

RENEGOTIATIONS AND CORRUPTION IN INFRASTRUCTURE: THE ODEBRECHT CASE

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Abstract

In 2016, Brazilian construction firm Odebrecht was fined \$2.6 billion by the US Department of Justice (DOJ). According to the plea agreement, between 2001 and 2016 Odebrecht paid \$788 million in bribes in 10 Latin American and two African countries in more than 100 large projects. The DOJ estimated that bribe payments increased Odebrecht's profits by \$2.4 billion.

Judicial documents and press reports on the Odebrecht case reveal detailed information on the workings of corruption in the infrastructure sector. Based on these sources we establish five facts. First, for projects where Odebrecht paid bribes, renegotiations amounted to 71.3 percent of initial investment estimates, compared with 6.5 percent for projects where Odebrecht paid no bribes. Second, Odebrecht's bribes were less than one percent of a project's final investment. Third, the profits Odebrecht obtained from bribes as well as its overall profits were relatively small: around 1 to 2 percent of sales. Fourth, the creation of the Division of Structured Operations (DSO) by Odebrecht in 2006 led to major reductions in the firm's costs of paying bribes and recipients' costs of hiding the illegal proceeds. Fifth, following the creation of the DSO, Odebrecht's sales multiplied tenfold in four years, while its profits remained relatively small.

We build a model where firms compete for a project, anticipating a bilateral renegotiation in which their bargaining power will be larger if they pay a bribe. If cost dispersion among firms is small, profits are small in equilibrium even when bribes are paid. When one firm unilaterally innovates by making bribe payments more efficient, its market share increases substantially while profits, which depend on cost advantages and the magnitude of bribes, remain small. The model provides a lower bound for the bribing efficiency advantage of Odebrecht. The DOJ's data implies that Odebrecht enjoyed a cost advantage in bribing of at least 70 percent.

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1 Introduction

It is commonly believed that corruption in infrastructure is widespread and costly, and that the bribes that firms pay to public officials and politicians are large. Yet the evidence on which these beliefs are based is limited. There are many open questions on the specifics of corruption, on how much firms pay politicians and public officials, and what firms receive in exchange for these payments.² In this paper we present novel evidence on how corruption works in the infrastructure sector, report reliable data on the amounts of bribes paid, and build a model consistent with our findings.

Our window into the workings of corruption is the Odebrecht case.³ In 2016 the Brazilian construction firm Odebrecht was fined \$2.6 billion by the US Department of Justice (DOJ). Between 2001 and 2016, Odebrecht confessed to paying \$788 million in bribes to politicians and public officials in ten Latin American and two African countries. These payments involved more than 100 contracts for major infrastructure projects. The DOJ estimated that by paying bribes, Odebrecht increased its profits by \$2.4 billion, the largest amount ever prosecuted under the U.S. Foreign Corruption Practices Act of 1977. The DOJ data on bribe payments, the legal statements of almost a hundred Odebrecht executives who planned, designed and managed the corruption scheme, and a host of media reports reveal novel facts about corruption in infrastructure.

Five facts that emerge from the Odebrecht case allow us to better understand the operation of corruption in infrastructure projects. The first fact is that the size of contract renegotiations is much larger for projects where bribes were paid than for other projects. We analyze all infrastructure projects won by Odebrecht in eight countries in Latin America during the period considered in the plea agreement with the DOJ. We find that in the 63 projects in which Odebrecht paid bribes, renegotiations increased investments by 71.3 percent, more than ten times as much as in the 27 projects where it did not pay bribes (6.5 percent).⁴ For Brazil we were able to obtain information for 105 out of 140 projects during the period. A similar pattern emerges: in the 72 projects with bribes, the renegotiated value averages 24.3 percent of initial investment, compared with 3.0 percent for projects with no bribes. Second, despite the fact that renegotiated amounts were large, the bribes that Odebrecht paid were small relative to total investment in the project: around 1 percent of initial investments.

Third, Odebrecht's profits, as a fraction of the initial project value, were small by various measures. As indicated in the plea agreement with the DOJ, Odebrecht's profits from bribe payments were approximately 3 percent of initial investments. And as shown in Appendix B, Odebrecht's overall profits during the period covered by the plea agreement were approximately one percent of total sales.⁵ The fourth fact is that Odebrecht became an innovator in bribing in 2006, by creating the Division of Structured Operations (DSO), a stand-alone department in charge of vetting bribes that paid bribes using transfers to off-shore

²For recent surveys see Svensson (2005), Zitzewitz (2012), Banerjee et al. (2012), Olken and Pande (2012) and Burguet et al. (2016).

³The Odebrecht case is part of the larger Lava Jato corruption case. For details, see Appendix E.

⁴The eight countries we consider are all countries in Latin America mentioned in the plea agreement, with the DOJ, with the exception of Venezuela (because of lack of data) and Brazil, for which we have incomplete data

⁵As shown in Appendix B, for an industry that is a byword for corruption, engineering and construction have low rates of profits on sales worldwide. The average return on assets is also low. This indicates fairly competitive markets for infrastructure, at least among the groups of countries considered in the appendix.

accounts rather than as cash payments.⁶ The fifth and final fact is that the creation of the DSO was followed by major increases in sales with no significant increase in profits.

Campos et al. (2019) includes case studies of 58 projects where Odebrecht paid bribes, revealing a variety of well known corruption mechanisms at play. For example, paying officials to structure bidding specifications to favor Odebrecht or to obtain a better evaluation in a subjective criterion included in the scoring function used to auction the project, Campos et al. (2019) also find that bribes led to more profitable renegotiations in 30 of the 58 projects considered. Additional profits obtained at renegotiations thanks to bribes took many forms. For example, it could help win a case presented to the dispute resolution instance, adding a major profitable project to the original contract and increasing payments to Odebrecht without requiring additional investments or higher service quality. The mechanism relating bribes with renegotiations is less known in the corruption literature and the direct evidence we provide here linking bribes to the magnitude of renegotiations is novel. For these reasons we focus on this mechanism in the simple model we develop in this paper.

The central assumption driving the model is that firms compete in an auction anticipating that they will earn rents in a renegotiation stage. This is Williamson's well known 'fundamental transformation.'⁷ This assumption is motivated by the observation that overall profits are small even though renegotiations are large when bribes are paid.

We begin by analyzing our model in the case where all firms draw their cost parameter from the same distribution and are equally efficient in bribing. This describes the equilibrium prior to the creation of the DSO. In the first stage of the game, firms compete in an auction for the contract; in the second stage the contract is renegotiated. In equilibrium, firms anticipate that, conditional on winning, they will renegotiate the contract. Because renegotiations are not competitive, firms obtain ex post rents, but competition in the auction forces each firm to bid below cost and dissipates ex ante rents. Our model shows that when firms pay bribes, lowballing increases in equilibrium and renegotiated amounts are larger than when they do not pay bribes.

Our model has additional implications that go beyond the observed correlation between bribes and renegotiations, and which are driven by competition in the auction. First, cost overruns are not unexpected, but result from the low bids in anticipation of renegotiations. Moreover, we provide content to the belief that large cost overruns suggest corruption. Essentially, bribes stimulate cost overruns because they increase renegotiation rents, thereby leading to lowballing in the auction. Second, we show that when all firms are equally efficient in paying bribes, their profits do not depend on the size of the bribes they pay, nor on the size of renegotiation rents. Thus there is no relation between bribes and firm profits. The reason is that when firms are symmetric in willingness to bribe and renegotiation ability, they compete away the rents created through renegotiation by lowballing in the auction. Because of this, the auction is decided only by cost differences and the most efficient firm wins. Bribes come at the expense of social surplus

⁶"Odebrecht, Latin America's biggest construction firm, had an upper hand over competitors by developing a secretive system to hide its bribes to foreign officials, politicians and political parties. It set up a special office, called the Division of Structured Operations, that funneled illicit money never reported on the company's balance sheet, according to the settlement." Wall Street Journal, December 22, 2016. *Odebrecht Bribery Scandal Shakes Up Latin America*.

⁷Firms have good estimates of the cost effects of renegotiations, see Bajari et al. (2014).

and the public purse and have no effect on firms' profits. Thus, from the point of view of the outcome of the auction, corruption and bribes do not distort firm selection. At the same time, because firms that pay bribes expect to earn more in renegotiations, they can bid more aggressively. Thus, firms that do not pay bribes are excluded from the auction—competition does not “protect” them.

Next we analyze the out-of-equilibrium episode that followed the creation of the DSO, with Odebrecht enjoying a cost advantage in bribing.⁸ Consistent with the facts, we assume that bribes are relatively small. When competition in the auction is intense, an advantage in bribing buys a large increase in the probability of winning, but only a modest increase in profits. Moreover, the increase in profits is approximately proportional and of the same order as the size of the bribes—exactly what we see in the data. This is reminiscent of Bertrand competition with homogeneous products: a small cost advantage generates a large change in market share but no commensurate increase in profits. Note that now the allocation in the auction may be inefficient since there is a probability (which depends on the relative efficiency of the DSO) that the most efficient firm is not selected in the auction. Nevertheless, if the cost advantage in bribing is small, the size of the inefficiency is also small.

A cost advantage in bribing following the creation of the DSO explains the observed increase in Odebrecht's market share without a significant increase in its profits. Indeed, our model implies that observed bribes and profits from bribing can be used to compute a lower bound of the cost advantage in bribing. When we estimate the lower bound with the DOJ data, we find that Odebrecht enjoyed a cost advantage of at least 70 percent in bribing—that is, Odebrecht had to spend only \$3 million when a competitor paid a \$10 million bribe.

The remainder of the paper is organized as follows. Section 2 discusses this paper's relation to the literature. Section 3 describes the facts on corruption in infrastructure revealed by the Odebrecht case. Section 4 builds a model aimed at explaining these facts in a coherent framework. This section also derives a (tight) lower bound for Odebrecht's efficiency gain in bribing following the creation of the DSO that can be computed with data on bribes paid and profits obtained from bribes. Section 5 concludes and is followed by several appendices.

2 Relation to the literature

Our paper contributes to the measurement of corruption. As Rose-Ackerman (1975, p. 187) notes, one essential aspect of corruption is bribing—an illegal transfer of money made to induce a public official in a position of power to act against the interest of the government.⁹ This definition is a clear prescription for measurement, but its use is limited because bribes and the quid pro quo are seldom observed.¹⁰ For

⁸A weakness of any industry study is that observed outcomes are the consequence of firms' unobserved strategies, which tell what would have happened, had firms not followed the equilibrium path. Yet, as noted by Sutton (1991, ch. 14), an observable technology shock may allow the researcher to observe strategies off the equilibrium path.

⁹Similarly, the World Bank (2004) defines a “corrupt practice” as “[...] the offering, giving, receiving, or soliciting, directly or indirectly, of anything of value to influence the action of a public official in the procurement process or in contract execution.”

¹⁰Exceptions are McMillan and Zoido (2004) (Montecinos in Peru); Olken and Barron (2009) (bribes paid by truckers in Indonesia); and Sequeira and Djankov (2010) (ports in Africa). Gorodnichenko and Peter (2007) estimated bribes paid to public officials in the Ukraine comparing government aggregate salary payments with the household expenditures of public employees reported in consumption household surveys.

this reason, in the case of infrastructure researchers have estimated the magnitude of theft instead. For example, Golden and Picci (2005) measured the difference between the cumulative disbursements made by the government when building the existing infrastructure and separate estimates of the physical quantity of existing public infrastructure in each Italian province. Olken (2007) measured the difference between what an Indonesian village government spent on a road, and a cost estimate by expert engineers. He found that missing expenditures averaged approximately one fourth of the total cost of the road.¹¹ Other researchers have developed proxy indicators for corruption—an outcome variable likely to be correlated with bribes. For example, Fazekas and Toth (2018) argue that the percentage of single-bidder contracts awarded in the European Union measures the degree of unfair restriction of competition in the procurement of transport projects and signals corruption. Collier et al. (2016) showed that unit cost of roads is 15 percent higher in countries where corruption, as measured by the World Governance Indicators, is above the median.¹²

In the case considered in this paper, however, the DOJ obtained direct information on bribes and the profits they generated. Odebrecht's executives described the *quid pro quos*, confessed to whom they paid bribes, and explained how they paid them. When this information is combined with the amounts invested and renegotiated in each project, and with profit and sales information from Odebrecht's financial statements, a fairly accurate estimate of the relative size of bribes and profits emerges.

It is fair to say that the generalized perception is that in major infrastructure projects firms pay large bribes and obtain large economic rents generated by overpriced contracts.¹³ According to this perception, bribed public officials use their discretionary authority to restrict entry, raise prices and steal vast amounts from the public purse. Nevertheless, our evidence suggests that—at least for most of the countries in which Odebrecht operated—firms did not receive large economic rents, and that public officials did not obtain huge bribes, at least relative to the size of the projects they oversaw and influenced. Thus, as Olken (2009) warns, studies that estimate the intensity of corruption by surveying perceptions should be viewed with caution.¹⁴

Our paper is also related to the literature on the industrial organization of corruption. A basic insight, due to Shleifer and Vishny (1993), is that a corrupt public official with power to exclude firms from a market can extract bribes by restricting quantity, thus increasing the value of a bribe, in the same way that

¹¹Several studies estimate theft by public officials in different activities. See, for example, Reinikka and Svensson (2004) (schools in Uganda), Fisman and Wei (2004) (custom's inspections between Hong-Kong and China), Hsieh and Moretti (2006) (Food for Energy humanitarian program, Irak), Olken (2006, 2007) (income redistribution through a food program and public works -respectively, Indonesia), Ferraz and Finan (2008, 2011) (electoral accountability, Brasil), and Niehaus and Sukhtankar (2010) (welfare programs, India).

¹²In the data base, Collier et al. (2016) use unit costs per kilometer or per square meter measured for 3,322 work activities in ninety-nine low- and middle-income countries.

¹³For example, Kenny (2009b) claims that in infrastructure between 5 and 20 percent of construction costs are lost to bribe payments. Mauro (1997) argues that the cost of a large infrastructure project is difficult to monitor. Rose-Ackerman and Palifka (2016) argue that large infrastructure projects are complex and, moreover, even a small fraction of the investment value creates large corruption rents. Golden and Picci (2005) and Kenny (2009a) argue that in large projects information is asymmetric, which makes it hard to detect inflated prices, inferior quality, or sluggish delivery. Also, in 2004 the American Society of Civil Engineers claimed that corruption accounts for an estimated \$340 billion of worldwide construction costs each year, around 10 percent of the global construction market value added of \$3.2 trillion.

¹⁴Olken (2009) compared the measure of theft he developed in Olken (2007) with perceptions by villagers. He found that perceptions tend to be biased and that the individual characteristics of the survey respondent (e.g., educational level) predict perceived corruption more accurately than actual corruption.

a monopolist creates a market power rent by restricting output.¹⁵ When several corrupt public officials have power to exclude, bribes are stacked, and quantity falls even more than with just one corrupt public official.¹⁶

Nevertheless, the confessions indicate that Odebrecht bought influence from politicians and public officials, but did not restrict quantity—that is, the number of projects—to raise price in any meaningful way. Moreover, relatively small bribes and profits indicate that a different mechanism was at work—Williamson’s fundamental transformation. As Williamson (1979, 1985) argued, when a contract is put to tender, there is *ex ante* competition when bidding for the contract, but a bilateral monopoly *ex post*. We add to this insight by providing evidence that *ex ante* competition can dissipate rents and profits through lowballing, even when bribes buy influence and increase the firm’s *ex post* bargaining power. Moreover, we show that when bribes buy influence and increase the firm’s bargaining power, a clear relation between bribes and renegotiated amounts emerges.

When modeling the interaction between the fundamental transformation, bribes and renegotiations in infrastructure, we borrow from—and also contribute to—three strands of the corruption literature. One strand studies the relation between competition among firms and the intensity of bribing. Rose-Ackerman (1975, p. 188) observed long ago that a competitive auction for a contract may eliminate bribes. Indeed, as shown by Ades and di Tella (1999), when competition dissipates rents firms have little left to pay bribes. The fact that Odebrecht made relatively small profits and paid relatively small bribes, therefore, suggests that competition in the tendering stage worked as the literature indicates. Of course, as Bliss and Di Tella (1997) show, public officials with power and discretion to restrict access can endogenously create the surplus to extract bribes.¹⁷ Nevertheless, small bribes relative to investment suggest that public officials could not (or would not) restrict access. More generally, the confessions of Odebrecht’s executives confirm that public officials in charge of the tenders did not have enough power to sell access to projects, and were subjected to controls that limited their discretion. This is an important insight, because many papers show that competitive auctions can be vulnerable to bribes and corruption.¹⁸ Yet the evidence of the Odebrecht case suggests that in several Latin American countries the institutions ensuring competitive auctions worked to a significant extent, despite rampant and widespread bribe payments.

A second strand of the literature notes that public officials that provide similar services may compete, thus reducing the size of the equilibrium bribe. This is the so-called supply side competition for bribes.¹⁹

¹⁵Firms often pay bribes in order to use an input or to obtain a permit which allows the firm to execute an activity. Because of this, the demand for bribes is derived from the demand for the final good and resulting bribes tend to be a significant percentage of the final good’s price.

¹⁶This is the well-known problem of Cournot complements. In 1838, Augustin Cournot demonstrated that when two upstream monopolists both post their prices to a downstream producer independently of one another, they charge higher prices and sell less than if they collude and choose a single, profit-maximizing price for both inputs. The implication is that two monopolies are worse than one. See Olken and Barron (2009) for a test of this theory with data from a field experiment, in which surveyors accompanied Indonesian truck drivers along a route and registered the bribes demanded by police, soldiers, and weigh station attendants.

¹⁷See also Amir and Burr (2015).

¹⁸For example, bribes may buy favoritism in the auction: see Arozamena and Weinschelbaum (2009), Burguet and Perry (2007), Koc and Neilson (2008); or buy favoritism *ex-post*—the favored bidder can change her bid to match a better bid—: see Burguet and Che (2004), Compte et al. (2005), Lengwiler and Wolfstetter (2010), Menezes and Monteiro (2006).

¹⁹See Rose-Ackerman (1975, ch. 7), Klitgaard (1988) and Shleifer and Vishny (1993). For recent empirical studies see Drugov (2010), Burgess et al. (2012) and Kiselev (2012).

The level of bribes is exogenous in our model. Nevertheless, the fact that observed bribes are small relative to the size of the projects, and that Odebrecht developed a large network of bribed public officials suggests that public officials compete, or that the amount of discretion they have is limited.

A third strand of the literature studies corruption in bilateral relationships, the appropriate setting to study renegotiations of infrastructure contracts. Rose-Ackerman (1975) argued that bribing was attractive when waiting was costly for the firm. Essentially, by bribing, the firm induces the public officials to reach an agreement faster.²⁰ The literature, however, typically assumes that bargaining is about the size of the bribe. In contrast, in our model the firm bribes to increase its bargaining power in a legitimate renegotiation, and this yields novel results. First, our theoretical analysis shows that ex post bargaining generates adverse selection—firms that are unwilling to bribe cannot compete for contracts.²¹ Second, the data suggests that Odebrecht accurately anticipated how much it would renegotiate in each project. Thus Odebrecht renegotiated small amounts when it did not pay bribes and large amounts when it paid bribes, but it did not incur losses in either case, on average.

Large renegotiations suggest that the governance of the post-tender stage is considerably weaker than the governance that oversees the tendering stage. This is consistent with Piga's (2011) observation that post-tender corruption is monitored less effectively by judges, authorities and the media. He argues that post-tendering monitoring is expensive and time consuming, more difficult, and requires more expertise than overseeing auctions.²² In any case, corruption in the post tender stage has attracted less research than corruption during auctions. An exception is Iossa and Martimort (2016). In their model a firm bribes a public official to induce him to misreport the realization of a shock. As in Iossa and Martimort (2016), in our model there is no bargaining over the bribe, and the bribe is paid in order to receive more favorable treatment, we contribute to this (still small) literature by endogenizing the link between post tender renegotiations and the auction for the contract.

Our application of the fundamental transformation also sheds light on the mechanism underlying large cost overruns, which routinely emerge in large infrastructure projects.²³ The endogeneity of overruns and its relation with renegotiations has been pointed out by Dewatripont and Legros (2005) and Engel et al. (2019a). We contribute to this literature by linking theoretically and empirically cost overruns, the anticipation of renegotiations, and bribe payments. Indeed, by establishing a systematic link between bribes paid and cost overruns, we provide some ground for the conjecture in the literature that cost overruns signal corruption.²⁴

Finally, our paper is also related to the literature on renegotiations of public-private partnerships (PPP) infrastructure contracts.²⁵ The first comprehensive empirical study of renegotiations of PPPs is Guasch (2004), who analyzed more than 1.000 concession contracts in Latin America and established a number of

²⁰On bargaining and bribes see also Fisman and Gatti (2011). Svensson (2003) studies how the level of an outside option affects the bribe that firms negotiate with corrupt public officials.

²¹Boas, Hidalgo and Richardson (2014) show that in Brazil, campaign donors win more public works contracts when their supported candidate is elected. The adverse selection effect is consistent with this finding.

²²See also Soreide (2002) who explains corrupt practices that emerge during contract execution.

²³The classic book is Flyvbjerg, Bruzelius and Rothengatter (2002).

²⁴See, for example, Locatelli et al. (2017).

²⁵In our database, 21 of the 90 projects are PPPs, while the remainder are public works.

facts, prominent among them that renegotiations are pervasive and that a large fraction occur during the construction stage. Several theoretical and empirical papers followed. Guasch et al. (2006) and Guasch and Straub (2006) developed a theory of the determinants of renegotiations. Guasch et al. (2007) and later Bitrán et al. (2013) applied the theory empirically to quantify the determinants of government-led renegotiations in Latin America. Guasch et al. (2008) empirically studied renegotiations in transport and water in Latin America.²⁶ Nevertheless, only Guasch and Straub (2009) studied the correlation between the frequency of renegotiations in transportation and water concessions in Latin America and a corruption indicator.²⁷ They found that in countries with worse corruption indicators, firm-led renegotiations occurred more often but government-led renegotiations were less frequent. Our study is the first that documents the explicit link between renegotiations and bribes.

3 Facts

Table 1 shows information about corruption, culled from Odebrecht’s plea agreement with the DOJ and other sources. The first two columns are derived directly from Odebrecht’s plea agreement. The first column reports bribes paid by Odebrecht in each country. The second column reports, as stated in the Statement of Facts in the agreement, “any profit earned on a particular project for which a profit was generated as the result of a bribe payment.”

Table 1 also reports the amount invested, both before and after renegotiations, for all Odebrecht projects in eight countries during the period considered in the agreement.²⁸ This total amounts to 90 infrastructure projects.

Our dataset considers all countries in Latin America mentioned in the plea bargain with the exception of Venezuela and Brazil. We do not include Venezuela because of major data limitations: it is the only country where Odebrecht was unable to estimate the profits it made from bribes in its plea agreement with the DOJ. In the case of Brazil we have incomplete data: we obtained information on initial investments and renegotiations for 105 out of 140 infrastructure projects. The facts reported in this section remain valid if we include these projects, but due to the incompleteness of the Brazil data, we document it in footnotes.

We used web scrapping of legal documents and the media to determine whether bribes were paid by Odebrecht for specific projects (see Appendix A for details). For robustness purposes, we present the evidence in two forms: using only legal evidence on bribes in a project and in combination with reports on project-specific bribes in the media.²⁹

With the data from these 90 projects (and additional sources) we establish the following facts. First, renegotiations were much larger when bribes were paid. Second, bribes were small relative to investments. Third, profits (overall profits and profits associated to bribes) were relatively small compared to the size

²⁶Guasch and Straub (2006), Andrés and Guasch (2008) and Andrés et al. (2008a, 2008b) are useful overviews of this line of research.

²⁷The corruption indicator is the annual country-level index from Political Risk Service, International Country Risk Guide.

²⁸Argentina, Colombia, Dominican Republic, Ecuador, Guatemala, Mexico, Panama and Peru.

²⁹We were able to obtain information on the size of bribe for 46 out of the 63 projects with evidence (legal or media) of bribes. For this reason we work with a dichotomous variable indicating that there is evidence on bribes for a given project and do not work with the bribe paid for each project.

Table 1: Profits and bribes according to the Department of Justice

| Country | Bribes (US\$MM) ¹ | Gross Profits from Bribes (US\$MM) ² | Investment (US\$MM) ³ | Period | Projects |
|---|---------------------------------|--|-------------------------------------|------------------|-----------|
| Argentina | 35 | 278 | 12,416 | 2007-2014 | 8 |
| Colombia | 11 | 50 | 1,828 | 2009-2014 | 4 |
| Dominican Republic | 92 | 163 | 4,534 | 2001-2014 | 16 |
| Ecuador | 33.5 | 116 | 3,466 | 2007-2016 | 10 |
| Guatemala | 18 | 34 | 384 | 2013-2015 | 1 |
| Mexico | 10.5 | 39 | 2,158 | 2010-2014 | 6 |
| Panama | 59 | 175 | 8,844 | 2010-2014 | 21 |
| Peru | 29 | 143 | 15,473 | 2005-2014 | 24 |
| Total (ctries. full info.)⁴ | 288 | 998 | 49,103 | 2001-2016 | 90 |
| Angola | 50 | 262 | | 2006-2013 | |
| Brazil | 349 | 1900 | | 2004-2016 | |
| Mozambique | 0.9 | | | 2011-2014 | |
| Venezuela | 98 | | | 2006-2015 | |
| Total (all ctries.)⁵ | 788 | 3159.9 | 49,103 | 2001-2016 | 90 |

¹The information comes from the Plea Agreement between Odebrecht S.A. and the Department of Justice (DOJ) United States of America, ²The term benefit as used in the Statement of Facts relates to any profit earned on a particular project for which a profit was generated as the result of a bribe payment. As stated in the agreement, for projects that resulted in profits to Odebrecht that were less than the amount of the associated bribe payment, the amount of the bribe payment was used to calculate the benefit, ³Initial investment: authors' calculations based upon legal and media sources, as described in Appendix A. ⁴These totals consider only data from the eight countries for which we have full information, that is, the countries in the upper half of the table. ⁵These totals add up the available information for every variable; therefore the number of countries considered varies across entries.

of the infrastructure projects. Fourth, the creation of the Division of Structures Operations (DSO) by Odebrecht in 2006 led to innovations in bribing technology. Fifth, following the creation of the DSO, Odebrecht’s sales multiplied tenfold in four years, while its profits remained relatively small.

3.1 Bribes and the size of renegotiations

Contract renegotiations of infrastructure projects, especially in the case of public-private partnerships, have long been suspected of being associated with corruption,³⁰ yet we are not aware of any previous direct evidence. The Odebrecht case provides direct evidence and confirms that there is a large and positive association between bribe payments and the size of contract renegotiations.

Table 2: Increase of investments after renegotiations

| | | <u>Evidence on bribes</u> | |
|------------------|---------------------|---------------------------|----------------|
| | | Legal | Legal or Media |
| <u>No bribes</u> | Number of projects: | 50 | 27 |
| | Simple avge.: | 27.6% | 18.4% |
| | Weighted avge: | 11.8% | 6.5% |
| <u>Bribes</u> | Number of projects: | 40 | 63 |
| | Simple avge. | 67.8% | 57.1% |
| | Weighted avge. | 80.9% | 71.3% |

Authors’ calculations using data from DOJ, media and investments as reported by government agencies.. All infrastructure projects during the period covered by Odebrecht-DOJ plea agreement in the eight countries in Latin America.

Table 2 shows the number of projects with bribes and the increase in project investments after renegotiations. The column labeled ‘Legal’ considers evidence on bribes from documents issued by courts and prosecutors. The column ‘Legal or Media’ also considers evidence on bribes from the investigative media.³¹ The fraction of projects with evidence of bribe payment is 44 percent under the first definition and 70 percent under the second definition. The second and third rows in each set show the increase in investment in the project after renegotiation, both weighted by initial project investments, and unweighted. It is clear that renegotiations of projects with bribes are far more generous to Odebrecht than in cases when no bribe has been paid.³² For example, if we consider evidence from legal documents and media sources, total investment in the 63 projects where Odebrecht paid bribes grew by 71.3 percent after renegotiations, compared with 6.5 percent for projects with no bribes.^{33,34,35} Appendix D reports regression results showing that the results described above are robust to including a variety of controls.

³⁰See Guasch and Straub (2009).

³¹See Appendix A for a detailed explanation of the distinction.

³²In Appendix C we show that this difference is statistically significant.

³³Bajari et al. (2014) examined 819 highway procurement contracts in California and found that the final price was, on average, 5.8% higher.

³⁴The fact that the difference between renegotiations with and without bribes is larger when considering weighted averages, suggests that the correlation between bribe payments and renegotiations increases with the size of the project.

³⁵The following table is analogous to Table 2, but adds the incomplete data set we were able to put together for Brazil. Even though overall levels of renegotiation are smaller, the main conclusion continues to hold: Renegotiations for projects with bribes were between 3 and 8 times larger than for projects without bribes. In Table 2 the equivalent range goes from 2.5 to 11.

3.2 Bribes and profits are small relative to investments

The second and third columns in Table 3 show bribe payments, as a fraction of both initial investments, I_0 , and investments including renegotiations, I_1 .

Bribes as a fraction of initial investments are small: around 0.5 percent if we consider all projects, between 1.2 and 1.5 percent if we only consider projects with bribes.³⁶ When we normalize by total investment, the fractions are obviously smaller: less than one percent in all cases.³⁷

Table 3: Bribes and associated profits, relative to investment

| | Number | Bribes/ I_0 | Bribes/ I_1 | Profits from bribes/ I_0 | Profits from bribes/ I_1 |
|--|--------|---------------|---------------|----------------------------|----------------------------|
| Projects with bribes (legal sources): | 40 | 1.52% | 0.84% | 3.74% | 2.07% |
| Projects with bribes (legal or media sources): | 63 | 1.19% | 0.69% | 2.93% | 1.71% |
| All projects: | 90 | 0.59% | 0.42% | 1.45% | 1.04% |

Authors' calculations. Projects with bribes determined from legal and media sources.
Investment data obtained from government agencies. See Appendix A for details.

The last two columns in Table 3 show profits from bribes, as a fraction of both initial investments, I_0 , and investments including renegotiations, I_1 . Profits generated by bribes are somewhat larger than bribes, but still small. Depending on the type of bribing evidence considered and whether pre- or post-renegotiation investment is used to normalize, profits from bribes vary between 1.0 and 3.7 percent. The latter is obtained when only considering projects for which there are legal documents with evidence of bribes and normalizing by investments before renegotiations.

Next we present three pieces of evidence that, taken together, suggest that Odebrecht's overall profits, relative to sales, also were small. First, Odebrecht's financial statements show that profits from its entire operation during the 2004-2014 period were \$2.5 billion, with sales of \$286.8 billion (see Appendix B).³⁸

| | | Evidence on bribes | |
|------------------|---------------------|--------------------|----------------|
| | | Legal | Legal or Media |
| <u>No bribes</u> | Number of projects: | 34 | 35 |
| | Simple avge.: | 11.6% | 11.2% |
| | Weighted avge.: | 5.3% | 3.0% |
| <u>Bribes</u> | Number of projects: | 71 | 70 |
| | Simple avge. | 35.0% | 34.9% |
| | Weighted avge. | 24.2% | 24.3% |

³⁶For Colombia, Ecuador, Panama and Peru the National Attorney has presented evidence suggesting that higher bribes than those mentioned in the DOJ-Odebrecht plea agreement were paid. Nonetheless, these percentages continue being small if these additional bribes are included.

³⁷Kaufmann (2005) and IMF (2016) estimate worldwide bribe payments at roughly 2 percent of GDP. The numbers we present here suggest that, at least in the infrastructure sector, bribe payments are less than one half of this estimate.

³⁸"Like many construction companies, the emphasis is on volume and keeping costs low, which explains Odebrecht's wafer-thin margins: in 2014, net profits were just \$210m from \$41bn of sales." Arrest brings Odebrecht into the spotlight. Financial Times, July 29, 2015.

That is, profits were approximately one percent of sales.³⁹ Second, the DOJ initially imposed a \$4.5 billion fine on Odebrecht, but the firm successfully argued that such a fine would lead to bankruptcy and ended up paying a fine of \$2.6 billion. Third, data from Forbes suggests that the net worth of the Odebrecht family during the period remained in the \$4-6 billion range.⁴⁰

While Odebrecht's profits as a percentage of sales were fairly low—approximately one percent—, paying bribes was profitable. To see this, note that according to its financial statements over the period covered by the plea agreement, Odebrecht made around US\$2.4 billion in profits. This is a reasonable 11.3 percent rate of return on equity in the period ending in 2014,⁴¹ albeit only a 1 percent return on assets. Moreover, recall that the DOJ estimated that by paying US\$788 MM in bribes, Odebrecht made about US\$3.2 billion in gross profits, that is, around US\$2.4 billion net, which happens to be close to the fine that the DOJ ultimately imposed, and close to the aggregate profits for the period. Therefore, it seems that most of the profits Odebrecht made during the period were due to bribes.

3.3 The Division of Structured Operations⁴²

In its 2016 plea agreement with the DOJ, Odebrecht admitted engaging in a massive bribery scheme beginning in 2001, in order to win business in many countries. A major development in this scheme occurred in 2006, when Odebrecht created the Division of Structured Operations (DSO) to manage bribe payments and illegal campaign contributions and make them more efficient. According to the DOJ, the DSO effectively functioned as a stand-alone bribe department within Odebrecht. The creation of the DSO was followed by strong growth both in sales and in bribe payments.⁴³ We argue next that the DSO provided Odebrecht with a competitive advantage in bribing that explains its rapid growth in market share.

Three Odebrecht executives and four experienced assistants worked at the DSO and were in charge of paying bribes into foreign accounts.⁴⁴ As mentioned by the DOJ, “to conceal its activities, the Division of Structured Operations utilized an entirely separate and off-book communications system [...] to communicate with one another and with outside financial operators [...] via secure emails and instant messages, using codenames and passwords.” The DSO also used a bespoke information management system (MyWebDay) for bookkeeping and to track information flow.

Bribe payments followed a clear organizational flow. Until 2009, the head of the DSO reported to the

³⁹There is no publicly available data for Odebrecht's profits in 2008.

⁴⁰Information from Forbes is available only for these years: \$4.5 billion for 2012, \$4.5 billion for 2013 and \$6.0 billion for 2014. See Anderson Antunes, “The Richest People in Brazil,” August 10, 2012; “The Richest People in Brazil 2013: The Full List,” September 9, 2013 and “The Complete List Of The 150 Richest People In Brazil”, September 18, 2014. Other sources suggest numbers within this range as well. For example, Wikipedia's list of wealthiest families in Brazil, accessed March 25, 2019, lists the Odebrecht family with \$3.9 billion in 2004.

⁴¹Though lower than the 15.8 percent average for our sample of Brazilian construction companies, see Appendix A.

⁴²This subsection is based on “Odebrecht and Braskem Plead Guilty and Agree to Pay at Least \$3.5 Billion in Global Penalties to Resolve Largest Foreign Bribery Case in History.” US Department of Justice. Office of Public Affairs. December 21, 2016, and other sources.

⁴³In his confession, Mascarenhas da Silva, the executive who headed the DSO, told the DAs that after the division was created in 2006, the amounts paid in bribes grew from an annual average of BR\$ 60-70 MM (no period mentioned) before the creation of the DSO to BR\$ 420MM in 2010 and BR\$ 720 MM in 2012. During the period 2005-2012, the exchange rate was approximately 1US\$=2BR\$. Source: <https://id1-reporteros.pe/asi-perdio-el-juego-odebrecht/>.

⁴⁴According to Marcelo Odebrecht's plea bargain with the DOJ, the DSO combined three compensation options: legal contributions to political campaigns, illegal contributions to political campaigns, and bribes paid to public officials and politicians.

highest executives of Odebrecht to obtain approval of bribe payments. Thereafter, a contract manager would deal with potential bribe recipients—public officials and politicians—and reported to the country manager. The country manager decided and paid small bribes with local funds, while larger bribes had to be approved in Brazil by a business leader who reported directly to the company CEO, Marcelo Odebrecht, who made the final decision.

Once a bribe was authorized, the DSO registered, managed, and made the payment through a complex network of shell companies, off-book transactions and off-shore bank accounts, that included the Antigua subsidiary of Austria’s Meindl Bank, acquired for this purpose by Odebrecht. An independently funded parallel cash trove (Caixa 2) was used to pay bribes and campaign contributions. In this way, the DSO reduced transaction costs for bribe recipients and helped establish long-term relationships between the company and corrupt officials.

Thanks to the DSO, the center knew how much was being paid in bribes and to whom, which minimized ‘leakage’, an important inefficiency associated with bribe payments,⁴⁵ as suggested by a major corruption case uncovered recently in Argentina.⁴⁶ In addition, paying bribes electronically is cheaper than carrying and laundering cash. And providing a sophisticated network to help conceal bribe receipts is also valuable for the corrupt officials involved and fosters long term relationships between bribe payer and bribe recipient.

3.4 Profitability and sales: Before and after the creation of the DSO

In this section we show that the creation of the DSO led to a rapid increase in Odebrecht’s revenues, without a corresponding growth in profits. While there were years of high profits, on average profits represented a small fraction of sales.⁴⁷

Figure 1 shows both sales and profits for the years 2004-2014,⁴⁸ using data obtained from Odebrecht’s annual reports. There is a large increase in sales in 2007, the year after introducing the improvement in their corruption technology. Sales increased by 57 percent that year, and until the Lava Jato case in 2014, the rate of increase in sales was 20 percent per year. However, the profitability on these sales remained limited and on average was close to 1 percent.

Figure 2 shows the evolution of revenues from the construction business for Brazil’s four largest construction companies, using data from Engineering News Record’s annual ranking of the 100 largest con-

⁴⁵According to the executive who headed the DSO: “When you are working with cash that’s off the books, it can disappear. So they needed someone who could guarantee it wouldn’t disappear.” See Michael Smith, Sabrina Valle, and Blake Schmidt. “No One Has Ever Made a Corruption Machine Like This One: There’s graft, and then there’s Odebrecht graft.” Bloomberg Businessweek. June 8, 2017.

⁴⁶This is the Bribery Notebooks scandal, also involving infrastructure projects. A driver transferred bagfuls of US Dollars between locations in Buenos Aires, including the house of then President Kirchner. In an interview with a newspaper, the official in charge of making the payments claimed that the cost of paying bribes in cash, which probably includes leakages, is about half the amount paid.

⁴⁷In Appendix B we present evidence suggesting that on average construction firms worldwide have a low ratio of profits to revenue. Moreover, their return on assets is low and the average return on equity of the firms we examined is below the average for all sectors in the US (see http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/roe.html). Indeed, Bajari et al. (2014) report that the profit margins of the publicly traded firms in their sample of contractors that bid for highway construction contracts in California is 3 percent.

⁴⁸As mentioned above, we recall that there is no publicly available data for Odebrecht’s profits in 2008.

Figure 1: Total revenues and total profits of Odebrecht

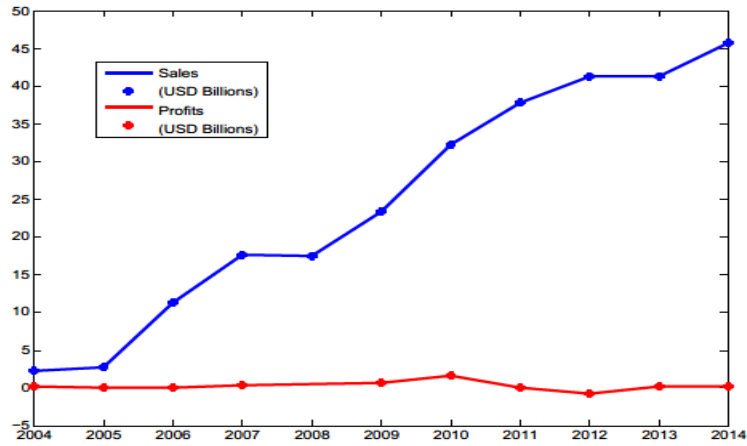
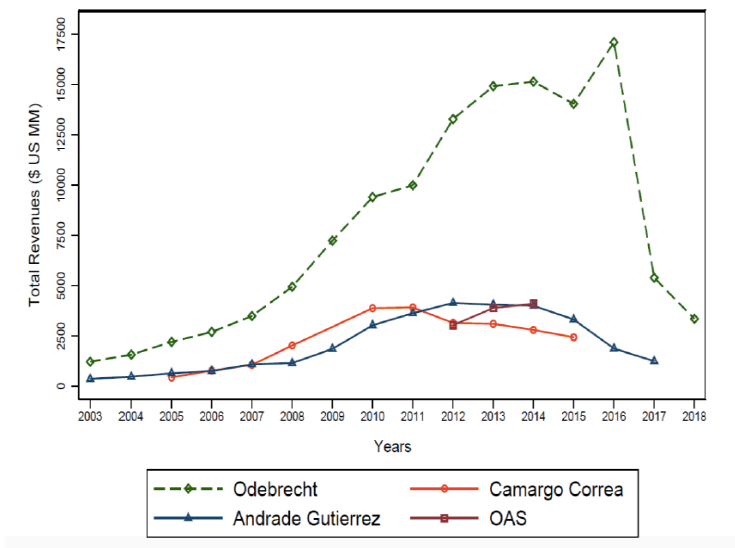


Figure 2: Total revenues from construction: Brazil's four largest firms



struction companies in the world by revenue.⁴⁹ In contrast with Figure 1, this figure only considers the construction business of these firms. The increase in Odebrecht’s participation relative to its Brazilian competitors is evident, as is the fall in revenues following the investigations into corruption.

In summary, the effect of improving the corruption technology was to increase sales, without affecting the low ratio of profit over sales. At the same time, bribing helped Odebrecht’s profits, which nonetheless were low by various measures.

3.5 Evidence from Odebrecht’s main competitors

Even though the data set we construct considers only Odebrecht projects, there is anecdotal evidence from its main Brazilian competitors that supports the framework we develop here. First, executives from the four major Brazilian construction companies—Andrade Guitierrez, OAS, Camargo Correa and Odebrecht—have faced corruption charges, spent time in jail and reached plea agreements. Second, a recent plea bargain states that OAS, a Brazilian competitor of Odebrecht, created its own version of the DSO. The Comptroller of Structured Projects (CSP) began operating in 2010, four years after the Odebrecht’s DSO. Figure 2 shows that OAS entered the select group of 100 largest construction firms in the world two years after it created the CSP. The bribe payments made by the CSP department between 2010 and 2014 amounted to an annual average of \$8.4 million. This sum is relatively small compared with Odebrecht’s annual average of \$82.1 million and suggests an advantage for the first innovator, possibly related to the long term relationships it established with bribe recipients.^{50,51}

4 Model

In this section we propose a model that accounts for the facts established in Section 3. When bribes are paid, the model leads to substantial lowballing and large renegotiations. In contrast, when no bribes are paid, the model yields small lowballing and small renegotiations. Furthermore, even when paying bribes, firms make small profits in equilibrium. Lastly, a firm enjoying a cost advantage in bribing sees a major increase in market share without a significant increase in profits.

Two assumptions, both consistent with the facts presented in Section 3, are central in our model. First, when firms pay bribes, they obtain a larger share of the surplus at the renegotiation stage than when they do not. Second, auctions are competitive and firms know that they play a dynamic game. It follows that projects are awarded to the lowest bid and firms incorporate into their bids the expected rents from renegotiations.

⁴⁹No data is available for a given company in a year where it was not among the 100 largest companies.

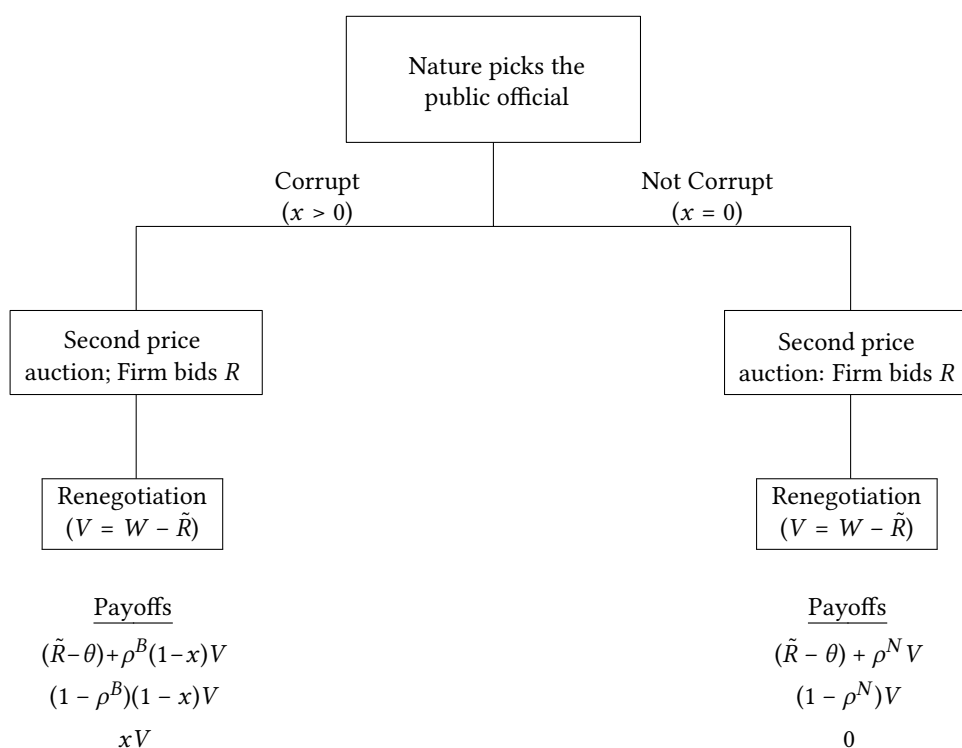
⁵⁰Since the time periods covered by Odebrecht’s plea agreement with the DOJ differ across countries (see Table 1) the annual average bribe payment by Odebrecht is obtained by adding up annual averages at the country level.

⁵¹See “Una constructora brasileña admitió millonarios sobornos y contribuciones a campañas,” *La Nación*, Buenos Aires, February 27, 2019; and “Cómo funcionó el Departamento de Sobornos de OAS”. IDL Reporteros. February 28, 2019.

4.1 Basic set up

Consider a project with gross value W . This value may reflect social welfare or, as in Rose-Ackerman (1975), the willingness to pay for the project, perhaps determined by the available budget that can be spent on it. There are many ex ante identical construction firms who can build the project. The cost of each firm, denoted by θ , is an i.i.d. draw from a normal distribution with mean $\bar{\theta}$ and variance σ^2 , and is private information. Hence, firms have asymmetric private information about construction costs. We assume that σ is much smaller than $\bar{\theta}$ so that $W > \theta$ with probability close to one. The project is in charge of a public official, who may be corrupt or not corrupt; only a corrupt official asks for bribes.

Figure 3: Timeline of the game



The time line of the game is shown in Figure 2. At the beginning of the game, nature decides whether the public official in charge of the project is corrupt or not corrupt. Knowing the type of the public official, firms compete in a sealed-bid, second-price auction with bidding variable equal to the amount they ask for building the project.⁵² In the second stage of the game, the winner of the auction and the public official renegotiate the contract. The surplus “up for grabs” when renegotiating the contract is $V = W - \tilde{R}$, the difference between the social welfare (or willingness to pay) and the second lowest bid, \tilde{R} .

Note that the game models Williamson’s (1979, 1985) fundamental transformation: construction firms compete in the auction, but the firm and the government behave like bilateral monopolies when they bargain at the renegotiation stage. We assume that if the public official is not corrupt, the firm receives a

⁵²We assume second-price auctions for simplicity. The Revenue Equivalence Theorem can be used to extend the insights that follow to the first-price auctions used to assign most of the projects we consider.

fraction $\rho^N \in (0, 1)$ of the surplus up for grabs, and the country receives the remainder. In this case, the firm's total payoff increases from $\tilde{R} - \theta$ to $(\tilde{R} - \theta) + \rho^N V$, and the country's payoff is $(1 - \rho^N)V$.

By contrast, if the public official is corrupt, he will ask for a bribe equal to a fraction $x \in (0, 1)$ of the surplus in exchange for an increase from ρ^N to ρ^B in the firm's bargaining power.⁵³ Thus, with a corrupt official the firm's total payoff increases from $\tilde{R} - \theta$ to $(\tilde{R} - \theta) + \rho^B(1 - x)V$. The country's payoff is $(1 - x)(1 - \rho^B)V$ and bribe payments to the corrupt official, which we assume are made by the winning firm, are equal to xV . As discussed in Section 3.1, the assumption that the firm increases its bargaining power by bribing follows from the confessions of Odebrecht's executives (see Table 2).

We note that we are assuming that construction firms have perfect foresight—they know whether the official is corrupt and they know that the contract will be renegotiated. Perfect foresight regarding contract renegotiation can be naïvely interpreted as the firms knowing the parameters of the actual second-stage bargaining game. Nevertheless, as argued by Bajari et al. (2014), by assuming that firms are risk neutral, one can rationalize the perfect foresight assumption via the more compelling assumption that firms have symmetric uncertainty about the ex post bargaining game. Independent of how one interprets rational expectations, this assumption is consistent with the empirical finding in Bajari et al. (2014), that construction firms correctly anticipate the post tender renegotiation game and contract modifications on average, when bidding in the auction. As we will see next, the assumption of rational expectation is necessary to rationalize the facts of the Odebrecht case, in particular, Odebrecht's overall modest profit

4.2 Competitive auction and renegotiation

Next we solve the game by backward induction. We consider the case where the firm pays a bribe and, for ease of notation, we write ρ instead of ρ^B . The results that follow also apply to the case where the firm does not pay a bribe if we set $x = 0$ and $\rho = \rho^N$.

If the firm wins and the second lowest bid is \tilde{R} , its profits are

$$\Pi(\tilde{R}) \equiv \tilde{R} - \theta + \rho(1 - x)(W - \tilde{R}), \quad (1)$$

where $\tilde{R} - \theta$ represents profits if there was no renegotiation while $\rho(1 - x)(W - \tilde{R})$ corresponds to expected profits due to renegotiation. The second period benefits are higher if the firm's bargaining power is higher (larger ρ). They also grow with the amount up for grabs at a renegotiation, $W - \tilde{R}$.

Denote the firm's bid by R . Because firms compete in a second price auction it is a dominant strategy to make a zero-profit bid. Hence, bids can be derived from the firm's zero profit condition:

$$R - \theta + \rho(1 - x)(W - R) = 0.$$

This yields

$$R = \theta - \frac{\rho(1 - x)}{1 - \rho(1 - x)}(W - \theta). \quad (2)$$

⁵³We assume ρ^N and ρ^B are constant for a given project. Since firms are risk neutral, all results presented in this section extend to the case where ρ^B and ρ^N are the expected value of the random variable that describes the firm's bargaining power when the official is corrupt and not corrupt, respectively.

Expression (2) implies that firms bid below their costs, that is, they anticipate that, conditional on winning, they will renegotiate the contract. Because renegotiations are not competitive, firms obtain a rent when they renegotiate. Competition in the auction then forces each firm to bid below cost and dissipate the renegotiation rent. Thus, the assumption of competition in the auction rationalizes the observation that firms obtain low profits even though renegotiations are large. Otherwise the firms would make rents when renegotiating in scenarios when their bargaining power is positive—i.e., when dealing with corrupt officials—and these profits would show up in their financial statements.

It follows from (2) that the firm lowballs by

$$\mathcal{L} \equiv \theta - R = \frac{\rho(1-x)}{1-\rho(1-x)}(W-\theta) > 0. \quad (3)$$

This amount is increasing in ρ and $W - \theta$. By contrast, a higher bribe (larger x) reduces the amount up for grabs during renegotiation of the contract and therefore reduces the amount of lowballing \mathcal{L} . We also have that the combination of a large value of ρ and small x leads to substantial lowballing. This leads to the following result:

Result 1 *Assume $\rho^B(1-x) > \rho^N$.⁵⁴ Then bids are lower and there is more lowballing when bribes are paid.*

Another implication of our model is that bribes, renegotiations and competitive auctions may exclude firms that do not pay bribes.⁵⁵

Result 2 *Assume $\rho^B(1-x) > \rho^N$. Then, a firm that decides not to bribe, when others are willing to bribe, faces a competitive disadvantage.*

Consider the firm's decision of whether to bribe or not in a project where bribes buy a larger value of ρ so that $\rho^B(1-x) > \rho^N$. The logic of Result 2 can then be appreciated by noting that (2) implies

$$R^B = \theta - \frac{\rho^B(1-x)}{1-\rho^B(1-x)}(W-\theta) < \theta - \frac{\rho^N}{1-\rho^N}(W-\theta) = R^N,$$

where R^B and R^N denote the firm's bid with and without bribes. That is, firms that pay bribes expect to earn more in renegotiations and bid more aggressively, thereby leaving at a competitive disadvantage identical firms unwilling (or unable) to pay bribes. Even though the auction is competitive, firms that do not pay bribes cannot compete because they cannot afford to lowball as much as firms that bribe. This result may explain why US firms rarely participate in the Latin American market for big infrastructure projects. The Foreign Corrupt Practices Act makes it less attractive for US firms to pay bribes than for local firms (or firms from other advanced economies), thereby deterring their participation.

⁵⁴This condition provides a lower bound on the increase in bargaining power that justifies paying a bribe.

⁵⁵The result that follows considers an extension of our model where firms may decide whether to pay a bribe or not when a corrupt official is in charge of the renegotiation

4.3 Symmetric equilibrium

Next we analyze the equilibrium prior to Odebrecht's innovation in the bribing technology in 2006. We consider a competitive auction with two identical firms.⁵⁶ As mentioned above, the project-specific values of θ for both firms are independent draws from a normal distribution with mean $\bar{\theta}$ and variance σ^2 .⁵⁷ The two firms have the same renegotiation parameter, ρ .⁵⁸

Denote by θ_i and R_i the cost draw and bid of firm i , $i = 1, 2$, Equation (2) then yields

$$R_i = \theta_i - \frac{\rho(1-x)}{1-\rho(1-x)}(W - \theta_i), \quad i = 1, 2. \quad (4)$$

It follows that

$$W - R_i = \frac{1}{1-\rho(1-x)}(W - \theta_i),$$

an expression we use on many occasions below.

Equation (4) implies that firm 1 wins if and only if $R_1 \leq R_2$, which is equivalent to $\theta_1 \leq \theta_2$, and which happens with probability 1/2. It follows from (1) that when it wins, firm 1's profits are given by

$$\Pi_1(R_2) = R_2 - \theta_1 + \rho(1-x)(W - R_2) = \theta_2 - \theta_1. \quad (5)$$

We conclude that firms' profits do not depend on the size of bribes nor on the renegotiation parameter. The intuition is that because firms are symmetric, they all lowball by the same amount and the auction is decided only by cost heterogeneity.

The public official expects to collect bribes in the amount of

$$B \equiv x(W - R_2) = \frac{x}{1-\rho(1-x)}(W - \theta_2), \quad (6)$$

so that bribe payments are increasing in x , ρ and W and decreasing in the cost of the less efficient firm.

The magnitude of renegotiations is given by:⁵⁹

$$\Delta I \equiv [\rho(1-x) + x](W - R_2) = \frac{\rho + (1-\rho)x}{(1-\rho) + \rho x}(W - \theta_2). \quad (7)$$

The effect of an increase in x on ΔI is ambiguous, since it reduces the firm's profits from renegotiating but increases bribe payments. The first effect dominates if and only if $\rho > 1/2$.⁶⁰

Social surplus (consumer surplus from the project or, alternatively, the surplus of the politician) is

⁵⁶The extension from two to n firms, with $n \geq 3$ given, is straightforward.

⁵⁷We will see below that the data suggest that σ is small. It follows that the fact that a normal distribution can take negative values is irrelevant in what follows as long as $W - \bar{\theta}$ is sufficiently larger than σ , say at least three times as large.

⁵⁸As mentioned above, we consider two firms that bribe, so that $\rho = \rho^B$ and $x > 0$. Nonetheless, the results also apply in the case with no bribes, albeit with $\rho = \rho^N$ and $x = 0$.

⁵⁹Since we assumed that the firm pays the bribe, this amount is equal to the sum of additional revenue obtained by the firm and bribe payments

⁶⁰We have $\partial \Delta I / \partial x = \{(1-\rho)^2 - \rho^2\} / [(1-\rho) + \rho x]^2$. It follows that ΔI is increasing in x if and only if $\rho > 1/2$.

given by

$$S \equiv \frac{(1 - \rho)(1 - x)}{1 - \rho(1 - x)}(W - \theta_2). \quad (8)$$

It follows that total surplus, that is, the sum of Π_1 , B and S , is equal to $W - \theta_1$. And since firms' profits depend only on productivity differences and not on the fraction of the surplus dedicated to bribes, we conclude that bribes are paid at the expense of social surplus. Also note that all projects that are socially valuable (or valuable to the politician) get built.

The expressions derived above combined with the evidence from Section 3 provide some basic insights on the magnitude of the model's parameters.⁶¹ First, (5) and small observed profits imply that cost heterogeneity has to be small, that is, that σ is small. Next we note that small bribes and (6) imply that x is small. Finally, a small value of x combined with the large renegotiations established in Section 3.1 and (7), imply that ρ^B is large. These insights are summarized in the following result.

Result 3 *Observing small profits, small bribes and large renegotiations implies that the values of σ and x are small and the value of ρ is large.*

Renegotiations are often attributed to unexpected cost overruns. Nevertheless, Results 1 and 3 suggest that cost "overruns" are endogenous and a result of lowballing in the expectation of a renegotiation. Moreover, the fact that construction firms make small profits even though renegotiated amounts are large, suggests that overruns are anticipated.

We end this section presenting an explicit expression for expected profits.

Proposition 1 (Pre-innovation equilibrium) *Two firms, with the same renegotiation parameter ρ , compete in an auction where bribes are paid. The values of θ for both firms are i.i.d. draws from a normal distribution with mean $\bar{\theta}$ and variance σ^2 .*

*Then, firm 1 wins if $\theta_1 < \theta_2$, which happens with probability 1/2. Profits, bribe payments and renegotiations are given by (5), (6) and (7), respectively. All projects with positive value are built, bribes do not lead to allocative inefficiencies—the firm with lowest costs builds the project—and expected profits for firm 1 (as well as firm 2) are given by:*⁶²

$$E[\Pi_1] = \frac{\sigma}{\sqrt{\pi}}. \quad (9)$$

Proof See Appendix E. ■

Observe that when σ is small, construction firms have similar costs and compete intensely in the auction. Consequently, profits are small, even though renegotiations are large. On the other hand, if cost dispersion is large, competition is less intense and profits are larger.

It also follows from Proposition 1 that expected profits do not depend on the bribing parameter x , nor on the renegotiation parameter ρ , that is, there is no relation between resources destined to bribes and

⁶¹In Section ?? we provide a detailed analysis of parameter values.

⁶²The expression that follows include the possibility that firm 1 does not win the auction. Expected profits conditional on firm 1 winning the auction are twice as large.

firm profits.⁶³ Technically this occurs because the lowballing expression vanishes from the firm's profit. The economics is that when firms are symmetric in terms of bribing and renegotiation, each pays the same bribe, and all bids are scaled down by the same amount. Thus, the auction is decided only by cost heterogeneity. An additional implication is that bribes do not affect firms' profits, because they are factored dollar-by-dollar into each firm's bid. Thus, because firms compete, bribes are fully paid by taxpayers.

4.4 Firm with a bribing advantage

Next we analyze the situation that follows the creation of the DSO in 2006. Starting at the equilibrium described above we assume that firm 1 (Odebrecht) innovates in the bribing business and only needs to pay a fraction $(1 - \gamma)x$ of the renegotiated amount to the corrupt official, instead of x . We assume that x does not depend on γ . The parameter $\gamma \in (0, 1]$ measures the size of the innovation, combining the reduction in leakage for the bribing firm and the decrease in transaction costs for the corrupt official, both as a result of the creation of the DSO (see Section 3.3). Otherwise the assumptions are the same as in Section 4.3.

That is, following Sutton (1991, Ch. 14) we test the model proposed above by determining Odebrecht's best response to a technology shock—the creation of the DSO—and verify that these predictions are consistent with what actually happened.

The time it took Odebrecht's competitors to create their own versions of the DSO cannot be very short for our model validation strategy to work. As mentioned in section 3.5, there is anecdotal evidence suggesting that Odebrecht's competitors were relatively slow in catching up with the new bribing technology.

With the same rationale that led to (2), and denoting $x_1 = (1 - \gamma)x$ and $x_2 = x$, we obtain that the i -th firm's bid will be:

$$R_i = \theta_i - \mathcal{L}_i,$$

with

$$\mathcal{L}_i = \frac{\rho(1 - x_i)}{1 - \rho(1 - x_i)}(W - \theta_i).$$

As before, the amount by which a firm lowballs in the auction increases with ρ . Note however, that the firm with the advantage in bribing will lowball by more than its competitor. Facing a reduced bribe payment increases the net surplus to be divided in the renegotiation, which in turn leads to a more aggressive bid.

Firm 1 wins if $R_1 < R_2$, that is if

$$\theta_1 < \theta_2 + \frac{\rho\gamma x}{1 - \rho(1 - x)}(W - \theta_2). \quad (10)$$

It follows that firm 1 may win even when it is less efficient than firm 2, a scenario that is impossible when firms have identical bribing technologies. This introduces an allocative inefficiency that was not present in the symmetric case.

⁶³Thus, in particular, (9) also is valid for projects where no bribes are paid, as long as the renegotiation parameter, ρ^N , also takes the same value for both firms in this case.

The expression for R in (2) in the symmetric case generalizes to

$$R_i = \theta_i - \frac{\rho(1-x_i)}{1-\rho(1-x_i)}(W - \theta_i), \quad i = 1, 2, \quad (11)$$

and therefore

$$W - \theta_i = [1 - \rho(1-x_i)](W - R_i), \quad i = 1, 2. \quad (12)$$

It follows from (1) and (11) that when firm 1 wins, its profit are equal to

$$\Pi_1(R_2) = R_2 - \theta_1 + \rho(1-x_1)(W - R_2) = (\theta_2 - \theta_1) + \frac{\rho\gamma x}{1-\rho(1-x)}(W - \theta_2). \quad (13)$$

The competitive advantage in bribing increases the firm's profits through two channels. First, the firm obtains higher profits in projects it would have won anyway, that is, projects where $\theta_1 < \theta_2$. This is the intensive margin. Compared with the symmetric case where the firm's profits are $\theta_2 - \theta_1$, for these projects the firm obtains an extra profit ('bribing rent') equal to the last term on the r.h.s. of (13). These rents are increasing in the parameter that determines the firm's bargaining power at the renegotiation, ρ , and in the parameters that characterize the magnitude of the bribe advantage (γ and x).

The second channel for additional profits (the extensive margin) comes from projects firm 1 wins thanks to the bribe advantage, that is, projects where its costs are higher ($\theta_1 > \theta_2$) and for which (10) holds. For these projects, extra profits ('bribing rents') are the only source of profits and therefore are bounded from above by the last term on the r.h.s. of (13). Yet, as discussed in Section 3.2, the rents Odebrecht obtained from bribes are approximately equal to its overall profits during the period considered in its plea bargain with the DOJ. This implies that the contribution to profits of the first term on the r.h.s. of (13), $(\theta_2 - \theta_1)$, is small compared with the contribution of the second term, $\rho\gamma x(W - \theta_2)/[1 - \rho(1-x)]$. It follows that second term provides a good approximation for bribing rents, both for intensive and extensive margin projects.

A small value of σ also implies that firm 1's market share following a bribing innovation will have a large increase. Firm 1 will win most projects (because σ is small) but rents from its bribing advantage will be small (because x is small as well).⁶⁴ The parallel of the above digression with Bertrand competition is evident. As is well known, the profits made by a firm that has a small cost advantage and competes Bertrand are equal to volume times the cost advantage. Thus our model suggests that Odebrecht's profits came mainly from its ability to create more "value" per dollar of bribe paid.

We formalize the above insights in the following proposition:

⁶⁴Note that social surplus (or the politician's surplus), when firm 1 wins is obtained by subtracting the firm's revenues and bribes from the project's gross value:

$$S_1 = W - (\Pi_1 + \theta_1) - (1-\gamma)x(W - R_2) = \frac{(1-\rho)[1-(1-\gamma)x]}{1-\rho(1-x)}(W - \theta_2).$$

We have that $\partial S_1/\partial x = -(1-\rho)[1-\gamma(1-\rho)]/[1-\rho(1-x)]^2 < 0$ and $\partial S_1/\partial \rho = -x\rho[1-(1-\gamma)x](W - \theta_2)/[1-\rho(1-x)]^2 < 0$. Also, it is straightforward to see that $\partial S_1/\partial \gamma > 0$. It follows that the surplus is decreasing in the bribe parameter x and in the renegotiation parameter, ρ , and increasing in the bribing efficiency parameter γ .

Proposition 2 (Firm with a bribing advantage) Consider the same assumptions as in Proposition 1, but allow for firm-specific values of the bribe parameter x : $x_1 = (1 - \gamma)x$ and $x_2 = x$ with $0 < \gamma \leq 1$. Define

$$C = \frac{\rho\gamma x}{1 - \rho(1 - x)}. \quad (14)$$

Then, firm 1 wins if and only if

$$\theta_1 < \theta_2 + C(W - \theta_2),$$

and the firm's profits, conditional on winning, are equal to

$$[\Pi_1 | \text{wins}] = \theta_2 - \theta_1 + C(W - \theta_2). \quad (15)$$

Define

$$\mu = C(W - \bar{\theta}), \quad \tau^2 = [(1 - C)^2 + 1]\sigma^2.$$

Then the probability that firm 1 wins and its unconditional expected profits are given by:

$$\Pr(\text{Firm 1 wins}) = \Phi(\mu/\tau), \quad (16)$$

$$E[\Pi_1] = \mu\Phi(\mu/\tau) + \tau\phi(\mu/\tau), \quad (17)$$

where Φ and ϕ denote the cumulative distribution function and probability density function of a standard normal random variable.

Proof See Appendix E. ■

We may use (16) and (17) to understand the effects of the creation of the DSO by Odebrecht. The parameter μ , which was zero before the DSO, becomes positive. As a result, Odebrecht's market share increases dramatically if μ/τ is large, that is, if σ is small or if ρ is close to one. With respect to profits, the comparative statics implied by (17) are non-monotone in most parameters, yet the following upper bound provides valuable insights:

$$E[\Pi_1] \leq \frac{\rho\gamma x}{1 - \rho}(W - \bar{\theta}) + \frac{\sigma}{\sqrt{\pi}}.$$

The first term on the r.h.s. bounds profits that result from the innovation in bribing. If x is small and ρ is not too close to one, these bribing rents will be small. The second term is the one we already had in the symmetric case.

The general lesson from Proposition 2 is that when there is intense competition in the auction (small σ) and bribes are small (small x), an advantage in bribing buys a large increase in the probability of winning, i.e., in the market share, but only a modest increase in profits. A competitive advantage in bribing implies a positive value of μ , thus μ/τ can be arbitrarily large when competition is intense and it follows from (16) that the probability that firm 1 wins will take values close to one. By contrast, it follows from (17) that expected profits will increase by little, since the first term on the r.h.s. is proportional to x and the second term is proportional to σ .

4.5 Bribing efficiency parameter γ

It follows from (13) that, conditional on winning a project (see (10) for a necessary and sufficient condition), Odebrecht's rents from bribing are given by:

$$\text{Rents} = \begin{cases} \frac{\rho\gamma x}{1-\rho(1-x)}(W - \theta_2), & \text{if } \theta_1 < \theta_2, \\ \frac{\rho\gamma x}{1-\rho(1-x)}(W - \theta_2) - (\theta_1 - \theta_2), & \text{otherwise.} \end{cases}$$

That is, for projects that Odebrecht would win anyway ($\theta_1 < \theta_2$), its advantage in bribing leads to extra profits that are proportional to the bribing efficiency parameter γ . By contrast, rents from bribing are lower—the difference equals Odebrecht's cost disadvantage $\theta_1 - \theta_2$ —for projects that Odebrecht wins thanks to its bribing advantage. Therefore

$$\text{Rents} \leq \frac{\rho\gamma x}{1 - \rho(1 - x)}(W - \theta_2), \quad (18)$$

with equality when $\sigma = 0$.

We also have that

$$\text{Bribes} = (1 - \gamma)x(W - R_2) = \frac{(1 - \gamma)x}{1 - \rho(1 - x)}(W - \theta_2), \quad (19)$$

where we used (11) in the second equality. Combining (18) and (19) yields

$$\frac{\text{Rents}}{\text{Bribes}} \leq \frac{\rho\gamma}{1 - \gamma}, \quad (20)$$

and therefore

$$\frac{\text{Rents}}{\text{Rents} + \text{Bribes}} = \frac{1}{1 + \text{Bribes}/\text{Rents}} \leq \frac{1}{1 + \frac{1-\gamma}{\rho\gamma}} = \frac{\rho\gamma}{\rho\gamma + 1 - \gamma}. \quad (21)$$

Since the right hand side of this expression is increasing in ρ , it will be bounded from above by the value it takes when $\rho = 1$, that is, by γ . This yields the following lower bound for γ :

$$\gamma \geq \frac{\text{Rents}}{\text{Rents} + \text{Bribes}}. \quad (22)$$

This bound increases with the ratio of rents to bribes, from zero in the case with no rents, approaching one as the ratio becomes large. We also note that the bound in (22) becomes an identity when $\sigma = 0$, since (18) holds with equality in this case.

Using the numbers reported by Odebrecht in its plea bargain with the DOJ (see the last row in Table 1), we obtain a lower bound for γ of 0.75. Computing rents and bribes for the 90 projects in Tables 2 and 3 yields $\gamma \geq 0.71$. We conclude that the reduction in leakage (for the briber) and transaction costs (for the bribe recipient) added up to a significant competitive advantage in the infrastructure business for Odebrecht.

The above bound implies that even though bribe payments were relatively small, Odebrecht's competitive advantage in bribe payments was large. For example, if a competitor needed to pay \$10 million to

bribe a public official, Odebrecht required at most \$3 million. Extrapolating from the anecdotal evidence presented in Section 3.3 (see footnote 46), we have that five of the seven million dollars saved by Odebrecht are explained by the elimination of leakage. Arguably, the remaining two million correspond to the corrupt official’s valuation of receiving bribes in a manner that seemed impossible to detect.

Figure 4: Market participation: Before and after the creation of the DSO

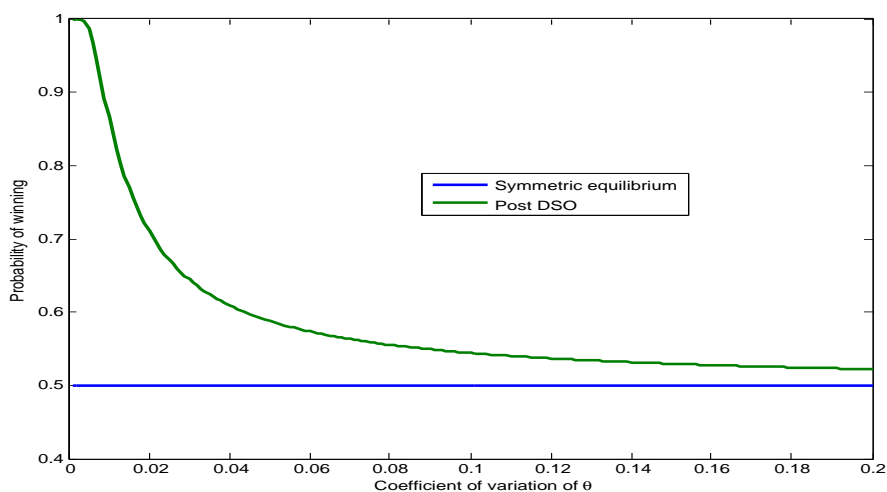


Figure 4 shows the probability of winning as a function of the coefficient of variation of θ , CV, both before (lower, green line) and after (upper, blue line) the creation of the DSO, that is, both in the symmetric equilibrium of Proposition 1 and in the post-bribe-innovation equilibrium of Proposition 2.⁶⁵ In the pre-innovation equilibrium, the probability of winning does not depend on the CV and is always 0.5. By contrast, in the post-innovation equilibrium the probability of winning jumps to 1 when the CV is close to zero and decreases as the CV grows, reaching 0.6 when $CV = 0.044$ and 0.55 when $CV = .088$.

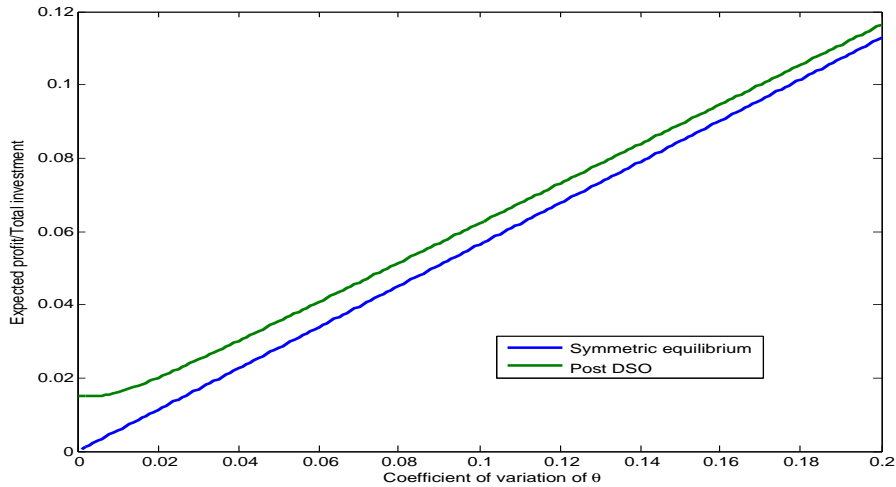
Figure 5 shows how profits, normalized by total investment, vary with CV, both before (lower, green line) and after (upper, blue line) the creation of the DSO. When $CV=0$, profits in the symmetric equilibrium are equal to zero, while following the innovation in bribing they are equal to $\tilde{\mu} = 0.2C = 1.51$ percent. As CV grows, the difference between pre- and post-innovation profits decreases systematically.

5 Conclusion

We began this paper by documenting a striking positive correlation between bribes and the amounts renegotiated. We also found that, even though corruption in the procurement of large infrastructure projects was widespread, Odebrecht paid relatively modest bribes and made relatively small profits, at least when compared with the magnitude of investments. Our formal analysis then showed that these outcomes stem from a subtle interaction between competitive auctions and bilateral renegotiations—a mechanism that

⁶⁵Parameter values used in this and the following figure are consistent with the facts presented in Section 3 and the lower bound derived for γ .

Figure 5: Profits as a fraction of total investment: Before and after the creation of the DSO



Oliver Williamson called the ‘fundamental transformation.’ To conclude, we discuss the open questions that emerge from this research.

The literature teaches that the aim of many corrupt transactions is to steal money from the public purse. When the aim of corruption is to steal, bribes are used to divide the proceeds between the corrupt official and the firm. The level of surplus extraction is the endogenous outcome of bargaining between the bribe payer and the public official. In the Odebrecht case, however, the main aim of bribing was not to steal, but to buy influence and bargaining power in renegotiations. That is, bribes are akin to the price of a service, and not a means of splitting the spoils. Because our aim in this paper was to understand the link between bribing and large renegotiations, we assumed that bribes were exogenous and small. But one would like to explain why small bribes emerge endogenously in equilibrium. Moreover, there are countries where the aim of corruption in large infrastructure projects is to steal. What determines whether one country ends in one or the other equilibrium is an open question.⁶⁶

The idea that firms bribe to buy influence has received comparatively less attention in the corruption literature, perhaps because influence is thought to be the outcome mainly of lobbying and campaign financing. Indeed, our model combines an illegal act (bribing) with an outcome that is not necessarily illegal—influencing the outcome of a renegotiation. One paper that studies the interaction of influence and corruption (or, in the terminology of Kaufmann and Vicente (2011), legal and illegal corruption). They model corruption at the macro level, and ask when one or the other form of corruption will prevail in a given country.⁶⁷ By contrast, the Odebrecht case suggests that some influence is bought with bribes and

⁶⁶One hypothesis is that the combination of competitive auctions with increased transparency of contracts and renegotiations limits the discretion of public officials. Similarly, improved disclosure of financial information for firms that operate in international bond markets limits the ability to generate funds available for bribes.

⁶⁷For example, as empirical proxies of legal corruption they use influence of well-connected firms in procurement, influence of legal contributions to political parties, independence of the judiciary from influence, and influence on laws and regulations. As proxies for illegal corruption they use illegal donations to political parties, diversion of public funds due to corruption, frequency of bribes in procurement, frequency of bribes in influencing laws and policies, and frequency of bribes in influencing judicial

that construction firms use both legal and illegal means of influence. Modeling the joint determination of both means of influence, as part of a portfolio decision, seems a fruitful line of research.

In our analysis we have barely touched on the relation between bribes, corruption and efficiency. Our model has rather conflicting implications. On the one hand, if competition in the auction is intense, then inefficiencies due to corruption are small. On the other hand, bribe payments may induce a self-selection effect—bribes exclude firms that do not pay them, because they cannot compete in the auction. The latter effect can be large if the renegotiating ability of firms is negatively correlated with technical efficiency (see Engel et al., 2019b for a formal model). Finding evidence to estimate the magnitude of this effect, however, remains an open question. Furthermore, understanding other channels that may affect the efficiency cost caused by corruption seems important as well. For example, an important question is whether corruption creates the incentives for poor project design and inadequate management that lead to large renegotiations; or rather that corrupt public officials take advantage of poor design and management to make their influence valuable in renegotiations.

The last observation is about the policy implications of our analysis. One is that, somewhat surprisingly, the Odebrecht case suggests that in many countries, even when affected by corruption, auctions of large infrastructure projects work fairly well—they are competitive.⁶⁸ Moreover, public officials seem to be unable to create rents by “selling” access to projects via large bribes. At the same time, the post tender stage seems to be working very poorly. A first and simple policy is to require that all the information on contract renegotiations of infrastructure projects be easily available to the public. A more ambitious, yet very simple reform follows from our analysis as well. As we have shown in Engel et al. (2019a), lowballing can be eliminated by increasing the government’s bargaining power in the post tender stage. Thus, as argued in Engel et al. (2014, ch. 8), one should subject renegotiations to independent review and approval by an expert panel, and award all additional post tender works in open auctions where the incumbent cannot participate.⁶⁹ Then influence will have little value and there will be no lowballing.

decisions.

⁶⁸The prevalence of competitive tendering is not a coincidence, but the result of decades of insistence that projects must be tendered in open and transparent auctions by development banks and other institutions. For example, at least since the 1990’s, the World Bank has promoted competitive bidding for the projects it finances. More generally, competitive bidding and at least some degree of transparency in public auctions for infrastructure have become fairly common in many developing countries, especially in Latin America. As Knack et al. (2017) find in a sample of 88 countries, more transparency in the procurement process foster firm participation in the bidding process because firms pay smaller bribes or kickbacks and less frequently. Also, Anh (2008) provides evidence that competitive bidding based on objective criteria (lowest price) reduces corruption while competitive bidding based on subjective criteria does not.

⁶⁹The 2010 reform of Chile’s legislation for public-private partnerships created such a panel and established the obligation of tendering additional works above a certain threshold excluding the incumbent from participating in the auction, see Engel et al. (2019c). Even though causality cannot be established, renegotiations during construction fell by more than 80 percent following the reform.

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APPENDIX

A Database

The main empirical fact emerging from the Odebrecht case is the systematic correlation between bribes and the size of a renegotiation. As we show in Table 3, on average, and conditional on having paid bribes, renegotiated amounts are about ten times larger in projects where Odebrecht paid a bribe. To establish this correlation, one needs to know, for each public project undertaken by Odebrecht, whether Odebrecht paid bribes, the estimated investment at the time of tendering (initial investment), and total investment after completion of the project (final investment). Nevertheless, the plea agreement only reports, country by country, the total amounts that Odebrecht paid in bribes, and the total profits it made by bribing. It neither reports investment by project nor lists the specific projects in which Odebrecht paid bribes.⁷⁰ In this appendix we explain how we obtained information about each project.

To capture the data we proceeded in three steps. First, from Odebrecht's annual reports and the websites of Odebrecht's subsidiaries in several countries, we obtained the list of public infrastructure projects awarded each year to Odebrecht in each country. When selecting projects, we only considered years covered by the DOJ's investigation, which vary across countries (see the next to last column in Table 1).

Second, two research assistants conducted systematic on-line searches to find the amounts invested (initial and final) by each project in the list, and evidence of bribe payments associated with each project. To do so, they downloaded all official documents issued by government and judicial bodies which mentioned a project in the list—e.g. contracts, minutes of the bidding process, supplementary contracts. In addition, they downloaded from JOTA.Info all documents issued by public prosecutors that mentioned a project in the list, and the depositions of Odebrecht executives.⁷¹ Last, they downloaded press reports that mentioned a project in the list.

Third, the number of downloaded pages is in the thousands. We therefore deposited the documents and press reports in a bespoke platform where they can be electronically searched by key words.⁷² We used key words to select documents that mentioned each project, and then two research assistants read them looking for the amounts invested and evidence of bribe payments.

So far we obtained the amounts invested and renegotiated for 90 public infrastructure projects in eight Latin American countries—Argentina, Colombia, Dominican Republic, Ecuador, Guatemala, Mexico, Panama and Peru.⁷³ This list comprises all projects that were awarded to Odebrecht during the years

⁷⁰Odebrecht's plea agreement states: "During the relevant time period, Odebrecht, together with its co-conspirators, paid approximately \$788 million in bribes in association with more than 100 projects in twelve countries, including Angola, Argentina, Brazil, Colombia, Dominican Republic, Ecuador, Guatemala, Mexico, Mozambique, Panama, Peru and Venezuela".

⁷¹JOTA.Info is a repository of the legal documents generated by the hundreds of processes that comprise Operation Lava Jato, of which Odebrecht's case is part. Operation Lava Jato is an ongoing criminal investigation of the Federal Police of Brazil, which began as money laundering investigation, but was expanded to cover allegations of corruption in the state-owned oil company Petrobras.

⁷²The platform can be found at <http://searchbench.unholster.com>.

⁷³When two sources provided different data for the same project, priority was given to information on contracts and official documents issued by the government. When this information was not available, the information provided by judicial bodies, investigative media and civil society organizations was used.

covered by the DOJ's investigation. We are still working on Brazil, and excluded Venezuela, Mozambique and Angola for lack of reliable information about project-specific bribe payments and investments.

In addition, for each of the 90 projects we looked for evidence of bribe payments. We concluded that a bribe was paid in a given project if an official document or a press report mentions at least one bribe payment. We call this *legal and media corruption*. Under this criterion, the number of projects with bribe payments is 63 (70 percent). To check the robustness of the association between bribe payments and renegotiated amounts we also built an indicator that concludes that a bribe was paid only if at least one official document mentions that a bribe was paid. This criterion is stricter and yields that the number of projects with bribe payments is 40 (44 percent).

B Profit rates in the construction industry

One of the striking features of the construction industry worldwide is that profitability, as a fraction of sales, is low. This may seem at odds with the notion that there is corruption in the industry, and that corruption would lead to large profits (and margins) for the corrupting firms. To examine this issue we have divided the world into groups of countries according to a somewhat idiosyncratic division into: Spanish Latin America, Europe without Scandinavia, Scandinavia, Japan, Korea, Australia, China, Brazil and the US.

Table 4: Average Profit Margin (profit/sales) by group of countries, in percent

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | Average |
|--------------------------|------|-------|------|------|-------|------|-------|-------|-------|-------|--------|---------|
| Sp. Latin America | 7.70 | 11.77 | 6.03 | 8.08 | 8.90 | 7.59 | 6.90 | 6.65 | 4.92 | 5.31 | 8.05 | 7.45 |
| Australia | 4.58 | 5.50 | 6.67 | 5.11 | 5.10 | 3.59 | 3.07 | 2.83 | 2.50 | 1.75 | 2.86 | 3.96 |
| Brazil | 8.90 | 7.91 | 6.58 | 7.49 | 4.70 | 6.28 | -3.39 | 2.20 | -1.43 | -7.70 | -22.23 | 0.85 |
| China | 2.16 | 2.66 | 2.28 | 2.54 | 2.08 | 2.48 | 2.50 | 2.45 | 2.54 | 2.71 | 2.83 | 2.48 |
| South Korea | | | | | 4.81 | 4.42 | 2.58 | -2.50 | -0.03 | 5.15 | -0.02 | 2.06 |
| United States | 3.03 | 3.11 | 1.90 | 3.46 | 3.78 | 3.89 | 2.25 | 3.35 | 3.35 | -0.48 | 0.06 | 2.52 |
| Scandinavian | 3.59 | 3.55 | 3.00 | 3.23 | 2.94 | 3.28 | 2.37 | 2.49 | 3.20 | 3.13 | 2.98 | 3.07 |
| Europe | 2.38 | 2.10 | 1.36 | 1.47 | 1.52 | 1.74 | 0.85 | 1.26 | 1.18 | 1.39 | 2.27 | 1.59 |
| Japan | 1.76 | 1.93 | 1.57 | 0.04 | -0.32 | 1.05 | 0.30 | 1.00 | 1.56 | 2.01 | 4.34 | 1.39 |

Source: Authors, from balance sheets and annual statements of the selected firms.

This division provides a fairly broad view of the industry, considering groups of countries with different levels of corruption according to the standard indicators (Transparency International's CPI and the World Bank Control of Corruption indicator). In each country group we have looked at the 5 largest firms that have (usually) audited financial information for recent years.⁷⁴ The average rate of profits on sales is very low, with Spanish LA firms having the highest rates, as shown in table 4. Even then it is a fairly low number, and seems consistent with the higher risks of the industry in Spanish LA. Thus, the low profitability of Odebrecht does not seem to be an outlier.

While the return on sales is highest for Spanish LA countries, the return on equity in LA for the

⁷⁴The firms are diverse, and often have divisions that are unrelated to construction. For example, Spanish firms have divisions that have operating PPPs, which are very profitable, but are unrelated to the construction of infrastructure. Some firms include mining services, another unrelated business. Unfortunately, the profitability of the Engineering and construction division –closest to our interest– in terms of assets and equity, or even of sales is usually unavailable.

Table 5: Average return on equity by group of countries, in percent

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | Average |
|--------------------------|-------|-------|-------|-------|-------|-------|--------|-------|-------|-------|-------|--------------|
| Sp. Latin America | 19.75 | 20.39 | 12.18 | 14.80 | 19.27 | 16.38 | 13.44 | 10.91 | 8.46 | 8.45 | 9.71 | 13.98 |
| Australia | 27.48 | 24.96 | 32.76 | 21.50 | 20.21 | 14.43 | 15.79 | 14.45 | 11.59 | 6.30 | 9.63 | 18.10 |
| Brazil | 36.15 | 30.10 | 32.15 | 35.89 | 17.20 | 16.71 | -16.71 | 9.81 | -6.28 | 3.10 | | 15.81 |
| China | 23.84 | 18.38 | 5.05 | 9.20 | 7.92 | 8.41 | 8.45 | 8.62 | 8.02 | 9.42 | 9.33 | 10.60 |
| South Korea | | | | | 12.32 | 9.94 | 6.31 | -8.29 | 0.58 | 6.53 | -4.50 | 3.27 |
| United States | 21.05 | 17.93 | 11.16 | 17.46 | 13.80 | 16.89 | 11.27 | 16.65 | 18.69 | -2.69 | -0.58 | 12.87 |
| Scandinavian | 28.77 | 29.08 | 25.00 | 21.85 | 16.06 | 20.80 | 16.33 | 15.98 | 21.22 | 19.35 | 18.62 | 21.19 |
| Europe | 34.33 | 6.70 | 5.58 | 5.96 | 5.83 | 7.60 | 3.48 | 4.82 | 4.69 | 5.50 | 8.64 | 8.47 |
| Japan | 7.34 | 7.92 | 7.87 | -0.57 | -0.58 | 4.55 | 1.10 | 3.93 | 5.53 | 6.68 | 13.13 | 5.17 |

Source: Authors.

period is 13.98%, which is smaller than the 18.10% return in Australia and the 21.19% return on equity in Scandinavia, see table 5. Scandinavia has low profits on sales, but the stability of the market means that firms require less capital in order to operate, leading to the highest RoE among the groups of countries analyzed. Thus the higher margin in Spanish LA may reflect a market in which higher margins on sales are needed to obtain a reasonable return. This is corroborated when considering the variation in the return on assets, as measured by the standard deviation of annual returns on assets, which ranges from 6.39% in Spanish LA to a 1.26% in Japan, see Table 6. Thus we conclude that this is an industry that is fairly competitive, without large margins on sales, but is reasonably profitable in terms of ROE. Observe that from the point of view of welfare, having low profits on sales means that the cost of a projects does not involve large rents for the construction company. The low margins on sales and standard profitability is important for our theoretical analysis.

Table 6: Average return on assets by group of countries, in percent

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | Average |
|----------------------|-------|-------|-------|-------|-------|------|-------|-------|-------|------|-------|---------|
| Latin America | 8.31 | 10.02 | 5.20 | 7.02 | 8.83 | 7.05 | 6.12 | 5.60 | 3.87 | 3.57 | 4.70 | 6.39 |
| Australia | 9.74 | 9.01 | 10.11 | 8.55 | 7.67 | 5.79 | 5.44 | 4.90 | 4.09 | 2.70 | 3.78 | 6.53 |
| Brazil | 17.48 | 13.61 | 15.14 | 11.66 | 3.59 | 5.14 | -3.99 | 2.03 | -2.38 | 1.00 | | 6.33 |
| China | 2.17 | 2.43 | 1.99 | 2.59 | 2.31 | 2.25 | 2.08 | 1.81 | 1.90 | 1.89 | 1.95 | 2.13 |
| South Korea | | | | | 4.32 | 3.73 | 2.49 | -1.88 | 0.08 | 2.56 | -0.34 | 1.57 |
| United States | 6.81 | 6.13 | 5.37 | 6.96 | 5.57 | 6.62 | 3.94 | 5.93 | 5.61 | 0.07 | 0.39 | 4.86 |
| Scandinavian | 6.35 | 7.09 | 5.53 | 5.32 | 4.62 | 5.17 | 3.71 | 4.04 | 5.43 | 4.80 | 4.78 | 5.17 |
| Europe | 4.02 | 2.68 | 1.70 | 1.92 | 1.81 | 2.30 | 1.09 | 1.48 | 1.44 | 1.70 | 2.72 | 2.08 |
| Japan | 1.49 | 1.66 | 1.49 | 0.05 | -0.35 | 0.88 | 0.27 | 0.91 | 1.44 | 2.02 | 4.04 | 1.26 |

Source: Authors.

C Statistical tests

Table 2 in the main text shows a large and positive correlation between bribe payments and the magnitude of renegotiations. In this appendix we provide a description of the data underlying this table and perform various statistical tests to establish that this difference is not only economically but also statistically

significant.

Table 7: Descriptive Statistics

| | Statistic | Projects considered | | | | |
|---|-------------------|---------------------|----------|-------------|--------|-------------|
| | | All | No bribe | | Bribe | |
| | | | Legal | Legal/Media | Legal | Legal/Media |
| | No. of projects: | 90 | 50 | 27 | 40 | 63 |
| <i>Initial investment, I_0</i> (MM USD) | Average: | 545.6 | 601.9 | 919.6 | 475.2 | 385.3 |
| | Median: | 203.4 | 174.3 | 172.4 | 220.4 | 220.8 |
| | St.dev.: | 1096.8 | 1345.7 | 1770.2 | 678.7 | 570.6 |
| <i>Total investment, I_1</i> (MM USD) | Average: | 755.9 | 673.1 | 979.7 | 859.5 | 660.0 |
| | Median: | 293.5 | 227.9 | 206.7 | 417.3 | 298.8 |
| | St.dev.: | 1552.6 | 1350.7 | 1774.8 | 1785.8 | 1452.0 |
| <i>Renegotiation,</i> $\text{Reneg} \equiv (I_1 - I_0)/I_0$ (% of initial investment) | Reneg > 0 (%): | 71.1 | 64.0 | 55.6 | 80.0 | 77.8 |
| | Simple avge.: | 45.5 | 27.6 | 18.4 | 67.9 | 57.1 |
| | Weighted avge.: | 38.5 | 11.8 | 6.5 | 80.9 | 71.3 |
| | St.dev.: | 58.3 | 39.3 | 25.1 | 69.9 | 64.4 |
| | Weighted st.dev.: | 64.4 | 28.3 | 16.3 | 80.7 | 77.4 |

Authors' calculations using data sources described in Appendix A.

Table 7 provides descriptive statistics for initial investments, I_0 , final investment, I_1 , and investment due to renegotiation, $(I_1 - I_0)/I_0$. The first column considers the 90 projects in our database, while the remaining columns separate projects between those where bribes were not paid and those where bribes were paid, using the two criteria for bribe payments (see Appendix A). For initial and total investment we report the average and median values as well as the standard deviation. In the section of the table presenting the percentage of initial investment that is renegotiated, we report the simple average and the weighted average, with weights proportional to initial investment. The latter equals the ratio of total final investment to total initial investment and therefore provides a natural estimate for the aggregate importance of renegotiations.

A comparison of means and medians, both for initial investment and for total investment, suggest distributions that are skewed right. By contrast, if we consider the same statistics for the logarithm of both initial and total investment, the distributions are approximately symmetric. The mean and median of log-initial investment for the entire dataset are almost identical (5.312 vs. 5.313) and the mean and median of log-total investment are similar as well (5.625 vs. 5.682).

The lower third of the table provides statistics for renegotiations as a percentage of initial investment. The first two rows show that differences between projects with and without bribes are larger when we consider weighted averages than when working with simple averages, for both bribe criteria, which suggests a positive correlation between project size and the increase in project renegotiation due to bribes.

Table 8 reports p -values for six tests comparing the means of the magnitude of renegotiations of

Table 8: Formal tests: p -values

| Variances | Method | Average | Bribe criterion | |
|-----------|---------------------------|----------|-----------------|-------------|
| | | | Legal | Legal/Media |
| Equal | t -distribution | Simple | 0.0008 | 0.0034 |
| Unequal | t -dist. (Welch approx) | Simple | 0.0019 | 0.0001 |
| Unequal | Bootstrap | Simple | 0.0014 | 0.0004 |
| Unequal | Bootstrap | Weighted | 0.0187 | 0.0091 |
| Unequal | Permutation | Simple | 0.0014 | 0.0004 |
| Unequal | Permutation | Weighted | 0.0040 | 0.0007 |

This table reports p -values for tests comparing the means of renegotiations of projects with and without bribes, both in percentages. Both definitions for projects with bribes are considered. The test statistic in all cases is the two sample t -statistic. The first column indicates whether variances are pooled (Equal) or not (Unequal). The second column indicates how the p -value is calculated. The first row uses the exact t -distribution (standard two-sample t test). The second row uses a t -distribution approximation (Welch test). The third and fourth rows use the bootstrap and the fifth and sixth rows use random permutation (Fisher's exact p -value test). The number of replications when using the bootstrap and permutations is 1,000,000. The third column indicates whether simple or weighted (by initial investment) averages are used.

projects with and without bribes. Both definitions for evidence-of-bribes are considered. The first test is a standard two-sample t test. The second test is the Welch test, that also assumes normal distributions but allows for unequal variances. Both these tests lead to small p -values, less than 0.002 in all cases. The remaining four tests consider non-parametric tests and therefore do not require the normality assumption. They use the bootstrap and permutations to calculate p -values. Even though the p -values with weighted averages are somewhat larger, all p -values are less than 0.02 and their average is less than 0.005.

The evidence presented in table 2 in the main text suggested an economically significant difference in the magnitudes of renegotiations of projects with and without bribe payments. Table 8 shows that this difference is also statistically significant.

D Regression analysis

In Section 3 we showed that renegotiations were considerably larger for projects where bribes were paid (see Table 2). In this appendix we undertake a more detailed analysis and report regression results on the magnitude and significance of the effect of bribe payments on renegotiated amounts, considering various controls.

Table 9 reports regression results, when the corruption dummy comes from evidence on bribes from legal sources (columns 1 and 2) or from both legal and media sources (columns 3 and 4). Columns 1 and 3 show that when the corruption dummy is the only explanatory variable, the renegotiated amount, as a fraction of the initial investment, increased by approximately 40 percent when bribes were paid. Columns 2 and 4 show that the estimated effect of bribe payments on renegotiated amounts changes little when additional regressors are included. Regressors considered are procurement type (competitive vs. bilateral bargaining), type of contract (PPP vs. public provision) and the initial size of the project.⁷⁵

⁷⁵We note that 70 projects were assigned competitively while the remaining 20 were assigned through bilateral negotiations. Also, 63 projects were provided as a public work, the remaining 27 as public-private partnerships.

Table 9: Renegotiated amounts, corruption (legal sources) and other determinants

Dependent variable: amount renegotiated, as a percentage of the initial investment

| | (1) | (2) | (3) | (4) |
|-------------------------------------|--------------------|------------------------|--------------------|----------------------|
| | Corruption measure | | | |
| | Legal | | Legal or media | |
| Corruption | 40.30** (12.37) | 38.31** (11.45) | 38.64*** (9.84) | 36.25** (13.61) |
| Type of procurement (competitive=1) | | -28.20* (17.93) | | -27.45 (19.07) |
| Type of contract (PPP=1) | | 6.00 (23.01) | | 7.33 (20.54) |
| Initial investment | | -0.000994 (0.00735) | | 0.00119 (0.00817) |
| Constant | 27.55*** (5.76) | 49.51*** (13.22) | 18.41*** (5.11) | 39.07* (18.24) |
| Observations | 90 | 90 | 90 | 90 |
| R^2 | 0.119 | 0.121 | 0.122 | 0.161 |

Notes: Standard errors clustered at country level are in parentheses. Corruption (legal in columns 1 and 2, legal or media in columns 3 and 4) is a dummy variable that considers evidence on bribes from documents issued by courts and prosecutors, see Appendix A for details. Initial Investment is measured in MM USD. *** p<0.01, ** p<0.05, * p<0.1.

The only control variable that is statistically significant (at the 10 percent level) is the type of procurement. Competitive procurement reduces renegotiated amounts, as a fraction of initial investment, by approximately 28 percent. If we build tables analogous to Table 2, one for projects with competitive procurement, the other one for projects with bilateral bargaining, then renegotiated amounts, both for projects without bribes and especially for projects with bribes, are larger when procurement is not competitive. For example, when we use evidence on bribe payments from legal and media sources, the (simple) average of renegotiated amounts, as a fraction of initial investment, increases from 17.7 to 48.9 percent when bribes are paid for projects that were tendered competitively, compared with an increase from 22.7 to 81 percent for projects assigned via a bilateral negotiation. This finding is relegated to the appendix due to data limitations: our regressions cannot include country fixed effects, since four of the eight countries in our database do not have projects in both categories (competitive and non-competitive). Furthermore, six of the eight countries in our sample have most of their projects (at least 85 percent) in one procurement category. We conclude that more data is needed to reach more definitive conclusions on this issue.

Summing up, simple OLS regressions find a large effect of bribes on renegotiations, effect in line with the numbers reported in Table 2, and robust to the inclusion of various controls.

E Proofs

Lemma 1 Assume X is a normal random variable, with mean μ and variance τ^2 and define

$$Y = \begin{cases} X & \text{if } X > 0, \\ 0 & \text{otherwise.} \end{cases}$$

Then:

$$E[Y] = \mu\Phi(\mu/\tau) + \tau\phi(\mu/\tau), \quad (23)$$

where Φ and ϕ denote the cumulative distribution function and probability density function of a standard normal distribution respectively.

Proof We have:

$$E[Y] = \frac{1}{\tau} \int_0^\infty y\phi((y-\mu)/\tau) dy = \mu \int_{-\mu/\tau}^\infty \phi(z) dz + \tau \int_{-\mu/\tau}^\infty z\phi(z) dz = \mu[1-\Phi(-\mu/\tau)] - \tau \int_{-\mu/\tau}^\infty \phi'(z) dz = \mu\Phi(\mu/\tau) + \tau\phi(\mu/\tau), \quad (24)$$

where we used that the p.d.f. of Y is $\phi((y-\mu)/\tau)/\tau$ and the Law of the Unconscious Statistician in the first step, the change of variable $y = \mu + \tau z$ in the second step, $\phi'(x) = -x\phi(x)$ in the third step, and $\Phi(x) = 1 - \Phi(-x)$ and $\phi(x) = \phi(-x)$ in the final step.

Proof of Proposition 1

Denote firm 1's profits by Π_1 . From (5) we have that

$$\Pi_1 = \begin{cases} \theta_2 - \theta_1 & \text{if } \theta_2 > \theta_1, \\ 0 & \text{otherwise.} \end{cases}$$

The expression for $E[\Pi]$ then follows from Lemma 1 with $\theta_2 - \theta_1$ in the place of X , so that $\mu = 0$ and $\tau = \sqrt{2}\sigma$. ■

Proof of Proposition 2

It follows from (10) and (13) that

$$\Pi_1 = \begin{cases} \theta_2 - \theta_1 + C(W - \theta_2) & \text{if } \theta_2 > \theta_1 + C(W - \theta_2), \\ 0 & \text{otherwise.} \end{cases}$$

The expression for expected profits then follow from Lemma 1, with $\theta_2 - \theta_1 + C(W - \theta_2)$ in the role of X , that is, with $\mu = C(W - \bar{\theta})$ and $\tau^2 = [1 + (1 - C)^2]\sigma^2$. ■

F The Odebrecht case in context

The Odebrecht case emerged during a wider corruption investigation called Lava Jato (car wash), centered on Petrobras, the Brazilian state-owned oil company. Petrobras confessed that between 2004 and 2012 several of its executives and contractors run a bid-rigging scheme and exchanged bribes for contracts.⁷⁶ Contractors paid bribes between one to three percent of the value of the contract, these payments were split between Petrobras's executives, politicians, and political parties. Among the contractors were the largest construction companies in Brazil, including Odebrecht, who used to run part of the bid rigging scheme.

As part of the Lava Jato investigation, it emerged that Odebrecht also ran an independent corruption scheme in several Latin American countries, which we describe in this paper.⁷⁷ In December 2016, 77 current and former Odebrecht executives entered a plea bargain with the Brazilian authorities. Marcelo Odebrecht, the company CEO, was sentenced to 19 years and 4 months in prison in Brazil for crimes of passive corruption, money laundering and criminal association. After spending two and a half years in jail, the sentence was reduced and he was placed under house arrest.

The U.S. DOJ had jurisdiction on Odebrecht because the company made payments from bank accounts in New York and some meetings to negotiate bribes were held in Miami.⁷⁸ In December 2016 Odebrecht entered a plea agreement with the DOJ for conspiracy to violate the anti-bribery provisions of the Foreign Corrupt Practices Act (FCPA). We use this agreement profusely in this paper.⁷⁹

The combined total amount of penalties imposed on Odebrecht was \$2.6 billion, the largest fine ever imposed under the FCPA. Odebrecht agreed to pay Brazilian authorities 80 percent of the total criminal penalty while dividing the remainder in equal parts between the American and Swiss authorities. Since then, the Odebrecht case has continued to evolve. So far Odebrecht signed cooperation agreements with prosecutors in six countries—the Dominican Republic, Panama, Guatemala, Colombia, Ecuador, and Peru. Several have imposed fines on Odebrecht.

⁷⁶Petrobras's plea agreement with the DOJ can be found at <https://www.justice.gov/opa/press-release/file/1096706/download>.

⁷⁷This paper only considers the projects covered in Odebrecht's plea agreement, which involves almost exclusively public infrastructure projects. Odebrecht's subsidiary in the petrochemical sector, Braskem, was also involved in a corruption case that was prosecuted separately under the FCPA.

⁷⁸See Fergus Shield and Sasha Chavkin, "Bribery Division: What is Odebrecht? Who is Involved?" in <https://www.icij.org/investigations/bribery-division/bribery-division-what-is-odebrecht-who-is-involved/>.

⁷⁹Odebrecht's plea agreement can be found at <https://www.justice.gov/opa/press-release/file/919916/download>. Braskem entered a separate plea agreement with the DOJ for conspiracy to violate the anti-bribery provisions of the FCPA, and agreed to pay a penalty of \$632 million. Braskem's plea agreement can be found at <https://www.justice.gov/opa/press-release/file/919906/download>.